LEGISLATION TO FURTHER REDUCE IMPEDIMENTS TO CAPITAL FORMATION

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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LEGISLATION TO FURTHER REDUCE IMPEDIMENTS TO CAPITAL FORMATION

Wednesday, October 23, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:28 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Huizenga, Grimm, Stivers, Mulvaney, Hultgren, Ross; Maloney, Sherman, Moore, Scott, Himes, Peters, Watt, Foster, Carney, Sewell, and Kildee.

Ex officio present: Representative Hensarling.

Also present: Representative Duffy.

Chairman GARRETT. Good afternoon. The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. And I welcome the panel and their indulgence as we just concluded votes for the morning until the next series of votes. Before we go to the panel, we will have opening statements, and I will begin by yielding myself 3 minutes.

Today's hearing, as you all know, is on legislation to further reduce impediments to capital formation for who? For America's small businesses. In a moment, I am going to recognize my colleagues for opening statements to introduce their legislative proposals. But first, I would like to briefly highlight a mixed bag, if you will, of recent developments in the area of small business capital formation.

First, data continues to flow in on the early impact of the JOBS Act and the results are very encouraging. Thanks in large part to the law's self-executing IPO on-ramp provisions, this is helping to shape up to be one of the best years for IPOs since 2007, and with more than 150 of them through the first three quarters and counting, it is a good track record. And so for our tech savvy crowd, I guess you could simply say with a hash tag the JOBS Act is working.

Now, in addition, while the SEC's statutory mission to promote capital formation has largely been ignored over the past 4 years, it does seem that the Commission is finally getting around to its responsibilities under the JOBS Act. Back in July, the SEC issued rules lifting the ban on general solicitation and advertising in connection with certain private security offerings to credit investors

and that was mandated by Title II of the JOBS Act. So this rule change was expected to be a milestone on the road to improving small business capital formation through the private securities market.

Unfortunately, in Washington these days things are never as simple as they should be. Instead of following Congress' straightforward and narrow mandate to lift the ban on general solicitation and advertising for certain private security offerings, the SEC also saw fit, over the objections of two Commissioners, to issue an additional, unrelated proposal to change the disclosure and filing requirements for these very same offerings.

This proposal, which was not called for by the JOBS Act, is apparently intended to protect the already more sophisticated investors who may participate in these offerings. However, it is likely to impose additional new and significant costs and burdens on small businesses who are trying to seek to raise capital through private security offerings and thereby reduce the attractiveness of these offerings and thereby undermine the very purpose of the JOBS Act in the first place.

So although Chair White wants the SEC to move expeditiously towards the adoption of this proposal, I would urge her and her colleagues on the Commission to seriously rethink whether it is the best option available to balance the SEC's important duties both to protect investors and to promote small business capital formation. Indeed, it seems that the SEC too often forgets that an important part of protecting investors is ensuring that they have access to a variety of investment options. And so with respect to the remainder of the JOBS Act, earlier today the SEC voted in favor of issuing proposed rules to implement Title III, the crowdfunding provisions. And, frankly, I have not had a chance to review the crowdfunding proposals. I hope that this time the SEC has stayed true to the terms of the statute. I also hope that a proposal from the SEC on regulation A will follow before the end of the year.

Now, on top of the JOBS Act, more can and should be done to help small businesses raise much-needed capital to grow and create jobs during this period of record-breaking government red tape, tepid economic growth, and persistently high unemployment.

And so, finally, to that goal, I would like to recognize the great work of Representatives Maloney, Grimm, Velazquez, and Mulvaney on their bills addressing the regulations of business development companies (BDCs). Also, we have Representative Huizenga on his bill addressing the regulation of mergers and acquisition brokers. Additionally, we have over here Vice Chairman Hurt on his proposal to create a voluntary filing exemption for small companies, and you have Representative Duffy's bill on his proposal to create the tick-size pilot program, and finally Representative Fincher on his proposals to improve Title I of the JOBS Act.

And with that, I will look to some of those Members later on for their opening statements, but at this point I would like to turn to the ranking member of the subcommittee, the gentlelady from New York, for 4 minutes.

Mrs. MALONEY. Thank you, Chairman Garrett, for holding this important hearing. And I want to particularly welcome Mr. Weild,

Mr. Arougheti, and Mr. Frank, who are all from the district that I am privileged to represent. This legislative hearing is the product of two informative hearings that this subcommittee held earlier this year, and I hope that this hearing will move our process forward.

The United States has the deepest, most liquid, and most effective capital markets in the world. The United States stock market is 13 times larger than the British and 14 times larger than Germany's. Simply put, the United States is where businesses come to raise money from investors. The sheer size of our stock market is attractive for investors because they know they will be able to sell their investment quickly if they need to.

But, unfortunately, small businesses still have trouble raising funds in these markets. Between 1991 and 2007, the number of small companies that went public in our securities markets declined by 92 percent. Providing incentives for greater investment in our country's businesses and our entrepreneurs will allow these companies to innovate, hire new workers, launch new products, and ultimately grow our economy.

However, we also need to keep in mind that one of the main reasons the U.S. markets are the envy of the world is the transparency and trust that come from public disclosure. I have always said that our markets operate more on trust and confidence than on capital.

That is why it is so important that we get the right balance between increased incentives for capital formation and healthy public disclosure that benefits all investors. We also need to make sure that any reforms we consider passing don't harm the tremendous improvements our markets have made in the past 3 decades.

As Chairman Garrett has noted, one of the big takeaways from the roundtable on market structure that he hosted earlier this year in New York was that today's retail investors have better access to the markets and at lower costs than ever before.

It is important not to lose sight of these benefits. And given what we went through with the financial crisis, it is also important that we put safety and soundness concerns first. As SEC Chair White has said, if there is a way to increase incentives for capital formation in a way that also protects the safety and soundness of the system, then we should work together towards that goal.

The bills that we are considering today represent a good faith and sometimes bipartisan effort to improve our markets and grow our economy. I look forward to a very informative discussion of these bills from our distinguished panel. Thank you for being here.

Chairman GARRETT. Thank you.

Mr. Hurt is recognized for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman. Mr. Chairman, I want to thank you for holding today's hearing on reducing barriers to capital formation. I am glad that this subcommittee is moving forward with additional proposals to increase access to capital for our small businesses and our startups.

Our hearings over the summer have shown that while the JOBS Act has been successful, more still needs to be done to ensure that we remove or refine costly regulations, especially those disproportionately affecting small or public companies and those who are

considering accessing capital in the public markets. While a single regulation's effect may appear insignificant, the combined costs of our regulatory climate produce exponential consequence. For that reason, I appreciate the subcommittee taking a holistic approach to examining our capital markets' regulatory structure and its impact on innovative companies.

One such requirement is related to the use of Extensible Business Reporting Language (XBRL), which was mandated by the SEC in 2009 and designed to lower the cost of capital for smaller companies and provide more efficient access to information for investors. While the SEC's rule is well-intended, this requirement has become another example of a regulation where the costs outweigh potential benefits. Smaller companies expend tens of thousands of dollars or more complying with the regulation, yet there is evidence that less than 10 percentage of the investors actually use XBRL, further diminishing its potential benefits. That is why I am interested in legislation to provide relief from the disproportionate burdens of XBRL.

The legislation under discussion would provide an exemption for emerging companies from complying with this regulation. It is important to note that nothing in the draft would preclude companies from utilizing XBRL for their regulatory filings with the SEC if they so choose. Rather, it allows these companies to assess whether the costs incurred with compliance are outweighed by any potential benefits from utilizing this technology.

I believe the draft offers a practical step forward with XBRL requirements in line with the intent of the JOBS Act, ensuring that our regulatory structure is not disproportionately burdening smaller companies and disincentivizing innovative startups from accessing our public markets.

I look forward to the testimony of our distinguished witnesses and thank them for their appearance before the subcommittee today. Mr. Chairman, I thank you, and I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from California is recognized for 2 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

We always have to balance on the one hand transparency and investor protection, which brings capital into our markets, with minimizing the costs of those companies trying to raise money. We should keep in mind that it is only for less than 2 centuries of human history that people invest with strangers, and they can do that only because we have a good and transparent accounting and financial reporting system that is reliable.

We can provide more capital to the smallest businesses doing something that is outside the scope of today's hearings, and that is allowing credit unions to make business loans. We bailed out banks that still aren't making the small business loans that they ought to be making, some of the giant banks. Here we have credit unions who just want the U.S. Government to get out of the way and let them make business loans, and we should be acting on that bill.

Finally, I want to recognize Mr. Quaadman of the Chamber for his work in preventing a grave threat to all business financings in-

volving borrowing from a $100,000 bank loan to a multibillion-dollar bond indenture, and that is the proposal of the Financial Accounting Standards Boards to "capitalize leases." This would add over $2 trillion to the liabilities listed on the balance sheets of unsuspecting businesses. Financial Accounting Standards Board exposure drafts are rarely on the front page of any newspaper, and so these businesses don't know what is about to possibly hit them. But most businesses that borrow have loan covenants, which means that if they added to their liabilities, even if they added an equal amount to their assets, and even if that addition wasn't a change in business but just a change in accounting principles, they would be in violation of their loan covenants and the money would be due immediately. That poses a risk to the financing of businesses that I hope this committee will look at separately.

I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from New York, Mr. Grimm, is recognized for 1½ minutes.

Mr. GRIMM. Thank you, Mr. Chairman.

And thank you, Mr. Mulvaney.

Chairman GARRETT. We appreciated the help from the gentleman for paying attention.

Mr. GRIMM. Thank you for calling the hearing. I appreciate it because it is extremely important that we discuss several legislative proposals that would increase capital formation and further economic growth and job creation. I am very proud to have introduced one of the bills under consideration today, H.R. 1800, the Small Business Credit Availability Act.

This commonsense legislation would increase the ability of business development companies, otherwise known as BDCs, to lend to small and midsized firms, the key drivers of new job growth in our economy. H.R. 1800 would allow BDCs to modestly increase their leverage, accurately reflect how their preferred stock is considered for regulatory purposes, and harmonize their securities issuance procedures with those of other registered firms.

At a time when our economy is still struggling to create jobs and erase the damage done during the great recession, we must strive to do all that we can to ensure the flow of much-needed capital to Main Street businesses and make sure they are not interrupted. In the wake of the financial crisis, BDCs filled an important void in the economy by continuing to provide much-needed capital to small firms. It is crucial that we ensure that they are able to continue in this vital role.

So I look forward to hearing from all the witnesses today. I would like their thoughts on BDCs and the other important legislation that is before us. And I yield back.

Chairman GARRETT. The gentleman yields back.

And Ms. Moore is recognized for 2 minutes.

Ms. MOORE. Thank you, Mr. Chairman. It sure is good to be back at work. I think that this is an auspiciously timed hearing after the whole shutdown debt ceiling episode, a step in the wrong direction, to be trying to now look at legislation that might promote positive, sustainable, and widespread economic growth.

I think there are very varying degrees of merit to the many ideas that are coming before this committee today, but I do think that this is an opportunity for the authors, the sponsors of these drafts to help us come to some kind of consensus.

I have not committed myself to any of these ideas, but I do think that proposals that my colleague from Wisconsin, Representative Duffy, on tick size, is of interest to me. The credit union business lending bill is of some interest to me. And I strongly encourage the sponsors to work with the SEC and State regulators on those proposals that impact the so-called accredited investors definition as a part of implementing the JOBS Act.

After some of the more high profile cases, like Bernie Madoff, I think this is a really, really critical undertaking by the SEC, and the committee needs to work in sync and be mindful of that process.

I thank you so much, Mr. Chairman and committee members, and I look forward to hearing from our witnesses.

Chairman GARRETT. Thank you. The gentlelady yields back.

Mr. Huizenga for 1 minute, please.

Mr. HUIZENGA. Thank you, Mr. Chairman, and Ranking Member Maloney.

Since 2006, the Securities and Exchange Commission has highlighted the merger and acquisition broker proposal as one of its top recommendations to help small businesses. However, 7 years later—count them, 7 years later—the SEC has not acted on this recommendation. I have been working with a constituent, Shane Hansen, who has been very involved in this, who had testified earlier, and that is why I, along with Representatives Brian Higgins and Bill Posey, introduced H.R. 2274, the Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act.

This bipartisan legislation would create a simplified SEC registration system for brokers performing services in connection with the transfer of ownership of smaller, privately held companies. It has been estimated that approximately $10 trillion, that is trillion with a "T," of privately owned Main Street mom-and-pop type businesses will be sold or closed as baby boomers retire. We don't want them closed, we want them sold so that they can continue. We must streamline and simplify the regulatory structure so small and midsized businesses are able to safely, efficiently, and effectively sell their companies while preserving and protecting jobs at these companies.

Thank you, Mr. Chairman. I appreciate the time.

Chairman GARRETT. The gentleman yields back.

The gentleman from Georgia for 2 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

I think it is very important for us to understand why the BDCs were put together in the first place. Back in 1980, Congress created the BDCs as a specialized type of closed-end investment company whose primary goal is to invest in and provide managerial assistance to small and growing and financially troubled domestic businesses. Today, there are 68 active BDCs with the total assets of $53.7 billion, and the BDCs are required to invest 70 percent—70 percent—of their funds in what are called eligible portfolio companies. These are private companies or publicly held companies with

a public float of less than $250 million, and an eligible portfolio company does not include mutual funds, hedge funds, or other private funds. But the BDCs do have a broader discretion regarding the remaining 30 percent of funds, so they are quite flexible.

Another feature of the BDCs is that they are also required to provide significant managerial assistance to eligible portfolio companies, which can include providing guidance on management, business operation of the company, and exercising or controlling influence over the company. And because they are publicly traded, BDCs provide a unique opportunity for retail investors to invest in private companies.

But I do have one concern here, and I hope that the committee, as we go forward on these three bills with our assessment of the BDCs and questions of how we can reduce barriers of capital formation through legislative means, that we must be mindful of how such adjustments that we might make might inadvertently divert capital away from the small growing businesses that the BDCs were originally created to help. As always, the hallmark of this committee is the delicate balance that we seek.

Thank you, Mr. Chairman.

Chairman GARRETT. And I thank the gentleman. The gentleman yields back.

Mr. Mulvaney is recognized for 1 minute.

Mr. MULVANEY. Thank you.

As the chairman noted, the purpose of today's hearing is to investigate the possibilities of reducing impediments to capital formation. And along those lines I am appreciative of the opportunity to include in the discussion today H.R. 1973, the Business Development Company Modernization Act, a fairly simple bill. For some reason back in 1980, the last time we changed this, we limited BDCs and their ability to invest in financial services companies. They can only invest 30 percent of their capital in those businesses.

I imagine that might have made sense in 1980. I have no idea why it would make sense today. These are companies that we excel at as Americans, excel at in their ability to employ people, to grow businesses, and I am interested in trying to see us get rid of what is admittedly an arbitrary cap. So I appreciate several members of the panel today who have said favorable things about H.R. 1973. I look forward to continuing that discussion today because I think it is a great opportunity for us to do exactly what we have talked about, which is improving capital formation.

With that, I thank the chairman for the opportunity.

Chairman GARRETT. And I thank the gentleman for his legislation and for yielding back.

And the last word on this will be Mr. Duffy for 1½ minutes.

Mr. DUFFY. Thank you, Mr. Chairman, and I appreciate the panel taking time out of their day to provide testimony to the committee. I have been working on legislation with the gentleman from Delaware, Mr. Carney, that would establish a pilot program that would allow emerging growth companies to trade at 5 and 10 cent increments. Why? We all know that America's number one job creators, our small businesses, still need help. Congress put aside partisan differences last year and passed the JOBS Act, which removed a number of barriers to raising capital to start a business.

It is only logical that the next step is to help improve the liquidity of emerging growth companies once public.

This is the main purpose of our proposal. It is no secret that the number of U.S.-listed IPOs raising less than $50 million has declined since the 1990s. Then, there were typically more than 100 such IPOs. Last year, there were less than 10.

Further, when the SEC implemented decimalization, larger companies saw an influx of investors, while our smaller companies saw their liquidity decrease. I believe that this issue can be partially remedied through reforms to our tick sizes for our small cap companies.

I look forward to all of your comments on how we could create better liquidity with increasing our tick sizes. And with that, Mr. Chairman, I yield back.

Chairman GARRETT. And the gentleman yields back, which concludes, I believe, the opening statements.

And now we can get to the matter at hand. So before you all begin, let me just remind you that your full written testimony will be made a part of the record, and you will now be recognized for 5 minutes. For those of you who have not been here before the committee before, you have a warning light that is in front of you: it is green when you start; yellow when it gets down to the last minute; and red when your time is up.

I also will probably ask each and every one of you to make sure that you bring the microphone closer to you than it is for just about everyone right now, since the microphone is very sensitive to that.

So with that being said, I now recognize Mr. Abshure, the Arkansas Securities Commissioner, testifying on behalf of the North American Securities Administrators Association. Thank you, and welcome to the panel.

STATEMENT OF A. HEATH ABSHURE, ARKANSAS SECURITIES COMMISSIONER, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. ABSHURE. Good afternoon, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am Heath Abshure, Arkansas Securities Commissioner. Until earlier this month, I was also the president of the North American Securities Administrators Association, or NASAA, the association of State and provincial securities regulators.

Prior to serving NASAA as president, I served as the chairman of both NASAA's Special Committee on Small Business Capital Formation and NASAA's Corporation Finance Section. In addition, since 2011, I have served as an observer member of the SEC's Advisory Committee on Small and Emerging Companies, which has recently considered a number of the same questions that will be examined at the hearing today.

I personally have a deep interest in small business finance and capital formation, and I am honored to testify for a second time before this subcommittee about these issues. In 2011, I testified before this subcommittee and expressed concern about many of the policies in the JOBS Act, including legislation directing the SEC to lift the ban on general solicitation in private securities offerings and to legalize equity crowdfunding. I remain deeply concerned

that some of the policies enacted under the JOBS Act, including in particular the lifting of the ban on general solicitation in Reg D, Rule 506 offerings, will be detrimental to investors and ultimately to the companies that rely on this method of capital formation.

The SEC is currently considering a number of proposed amendments to the general solicitation rule adopted in July pursuant to Section 201 of the JOBS Act. State securities administrators strongly support many of the proposed amendments, and we consider it particularly essential that the Commission move swiftly to adopt the requirement that Form D be filed prior to the use of general solicitation.

Today, the subcommittee is considering a number of new bills related to capital formation. NASAA's view regarding this new collection of bills is mixed. NASAA supports a number of these proposals, especially the proposed Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act sponsored by Congressman Huizenga. NASAA also understands the need for some delay or regulatory forbearance for small businesses that may be struggling to meet the SEC's requirement that certain filings be made using Extensible Business Reporting Language.

At the same time, NASAA has concerns with other legislation pending before the committee today. Most notably, NASAA is troubled by the proposal to further expand what are basically new, untested regulatory carve-outs for emerging growth companies. NASAA is additionally dismayed by proposals to increase leverage limits with respect to the investment activities of business development companies and strongly opposed to allowing BDCs to invest in financial services companies, including investment advisers. In our view, such policies would invite problems such as conflicts of interest, dilution of common shareholders, and investment risk due to lack of transparency. These policies would turn BDCs into speculative hedge funds for unsophisticated, nonaccredited investors.

In addition, NASAA cannot help but observe that competition from financial services firms will not benefit traditional BDC portfolio companies, meaning small operating companies that produce goods or provide services. If Congress were to enact such changes, the result would be that small businesses which create jobs in the real economy would be forced into competition with financial firms for BDC capital. This would frustrate the subcommittee's goal of spurring job growth. BDCs were initially created for the purpose of providing capital to domestic small and medium-sized businesses that participate in the real economy and not jobs in the financial services industry.

Finally, there are some bills before the subcommittee, including notably Congressman Duffy's bill dealing with tick sizes, on which NASAA does not have a strong stakeholder interest. In discussing these bills, I will offer my own personal observations based on my experience as a securities regulator, as well as the many discussions I have had with other regulators, academics, and industry participants as part of my work on the Advisory Committee.

Thank you again, Chairman Garrett and Ranking Member Maloney, for the opportunity to appear before the subcommittee today. I would now be pleased to answer any questions you may have.

[The prepared statement of Commissioner Abshure can be found on page 42 of the appendix.]

Chairman GARRETT. And the gentleman yields back. Thank you.

Mr. Arougheti is now recognized for 5 minutes. And welcome to the panel.

STATEMENT OF MICHAEL J. AROUGHETI, CHIEF EXECUTIVE OFFICER, ARES CAPITAL CORPORATION

Mr. AROUGHETI. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify today. I am Michael Arougheti, the CEO of Ares Capital Corporation, a BDC that has invested more than $14 billion in more than 450 small and medium-sized companies, creating tens of thousands of American jobs.

Congress created BDCs in 1980 to encourage capital flows to small and medium-sized business at a time much like today when these businesses had limited options for securing credit. Uniquely, the BDC model allows ordinary investors to participate in this process, effectively Main Street funding Main Street.

I have been asked today to testify on behalf of the BDC industry to express my support for the three pieces of proposed legislation, and I think it is important to note that the BDC industry is not seeking any government or taxpayer support or subsidy.

Many of the challenges faced by BDCs arise out of their peculiar place in the regulatory framework. BDCs are more akin to operating companies and commercial finance companies than mutual funds. We are a proverbial square peg in a round hole.

Three bills have been introduced into the House regarding BDCs. H.R. 1973, introduced by Congressman Mulvaney, offers welcome flexibility for BDC investment in financial institutions and finance companies. For example, a BDC investing in a growing leasing company might have to curtail useful lending to small business because of a limit that in context feels quite arbitrary.

H.R. 31 and H.R. 1800 contain 4 nearly identical provisions which we believe illustrate the significant bipartisan support for these initiatives. First, both bills propose an increase in the BDC asset coverage test from 200 percent to 150 percent. We don't believe that this introduces more risk. Rather, it should broaden the universe of potential borrowers and allow BDCs to invest in lower yielding, lower risk loans that don't currently fit in our economic model. In fact, the current asset coverage test may ironically be forcing BDCs to invest in riskier, higher yielding securities in order to meet the dividend requirements of its shareholders.

We also believe that this change will grant borrowers greater financing alternatives at a reduced cost and will benefit shareholders with more conservative diversified portfolios. This proposed change would apply to BDCs the same leverage ratio as small business investment companies, but unlike SBICs, without putting any government capital at risk. In fact, I also believe that this is extremely modest relative to typical bank leverage, which can exceed 10 times or greater. Under the current asset coverage test, most BDCs currently operate at leverage significantly less than allowed. A prudent manager would likely continue this practice if the asset coverage were to change.

Second, both bills would allow BDCs to treat preferred stock as equity rather than as debt. Had BDCs been able to raise capital during the post-2008 period by issuing preferred shares as equity, many more loans could have been made and many more jobs created.

Third, both bills direct the SEC to make specific technical amendments to certain securities offering rules that make raising capital cumbersome and inefficient. These rule changes aren't controversial and would merely place BDCs on equal footing with non-BDC entities.

And fourth, both bills would restore BDCs' ability to own registered investment advisers, a right that was inadvertently structured away.

Importantly, the first two provisions of these bills would become effective immediately upon passage. The other provisions will require action by the SEC.

So in closing, we are encouraged by the bipartisan focus on this important initiative, and we look forward to working with Representative Grimm, Representative Velazquez, and Representative Mulvaney, as well as Chairman Garrett, Representative Maloney, and the rest of the committee in moving this important initiative forward. Thank you.

[The prepared statement of Mr. Arougheti can be found on page 58 of the appendix.]

Chairman GARRETT. And I thank you.

Mr. Ertel is recognized for 5 minutes. And welcome.

STATEMENT OF J. MICHAEL ERTEL, MANAGING DIRECTOR, LEGACY M&A ADVISORS, LLC

Mr. ERTEL. Chairman Garrett, Ranking Member Maloney, and members of the Capital Markets Subcommittee, thank you for this opportunity to explain how today's one-size-fits-all system of regulating securities broker-dealers adversely impacts owners of privately held companies who seek professional advice and business brokerage services to sell, buy, or grow their small and midsized businesses through privately negotiated transactions.

Public policy considerations supporting H.R. 2274 go back to at least 2005 and have been well-documented in the oral and written testimony submitted by Shane Hansen, securities law partner with Warner Norcross & Judd, who testified before this committee on June 12th.

My testimony is based on my experience as co-chair of the Campaign for Clarity, a profession-wide effort to bring clarity to the regulation of M&A advisers and business brokers, which has been led by the Alliance of Mergers & Acquisitions Advisors and supported by at least 17 other regional, national, and international associations of M&A advisers, business brokers, and related professionals. My testimony is also based on my experience in providing business brokerage and M&A advisory services to sellers and buyers of privately held businesses since 2000 and being a small business owner myself.

Since July 2011, I have been a registered representative with an SEC and State-registered broker-dealer and FINRA member, but I am not speaking for or representing that firm in my remarks

today. I became a registered rep because in 7 years of persistent appeals by the Campaign for Clarity, the SEC has yet to address this critical small business issue through rulemaking.

For most business owners, the sale of their business is one of the largest personal financial transactions of their lives, but something they may do only once. While they may be experts at managing and growing their own business, they have little or no experience in preparing their company for sale and getting it sold and closed. While their attorneys and accountants will provide valuable advice, astute business owners recognize they may need an experienced professional to quarterback the entire multidisciplinary business sale process from start to finish.

Most business sales start with the buyer preferring to acquire business assets and the seller preferring to receive all cash at closing. Such a transaction would be exempt from Federal and State securities regulation. But for a variety of legitimate business and personal reasons, the structure of the transaction may morph to one that involves the purchase, sale of the company's stock or may include an earnout or a seller's note, any of which could arguably convert this business sale to a securities transaction. The final deal structure is generally not known until very late in the business sale process, which can run for months or even years.

In facilitating the sale of an ongoing business, M&A advisers and business brokers are not in the business of selling securities, nor do they raise capital, nor do they hold anyone's funds or securities, nor do they invest funds for the account of others. Nonetheless, the current one-size-fits-all regulatory scheme requires business brokers and M&A advisers to hold the same FINRA classifications and comply with the same Federal and FINRA regulations as Wall Street investment bankers and retail securities brokers.

The cost to organize and operate a FINRA member broker-dealer for the first 12 months has been estimated at $150,000 to $250,000. For most business brokers and M&A advisers, this is prohibitive. Since many business brokerage firms and M&A advisory firms do very few transactions per year, occasionally none in some years, and since not all transactions are subject to securities regulation, the cumulative cost attributable to an occasional securities transaction can be very, very substantial. Ultimately, these costs must be passed on to the business buyers and sellers.

In summary, professional and cost-effective business brokerage services facilitate capital formation and promote economic growth, job preservation and creation by small and midsized businesses. H.R. 2274 would direct the SEC to create a simplified system of M&A broker registration through a public notice filing and would require disclosure to clients about the M&A broker similar to those required of investment advisers today. The bill would direct the SEC to review and tailor applicable rules to fit this business context. This directive from Congress to the SEC will ultimately free up resources to better protect our public markets and passive investors.

I urge you to support H.R. 2274, and I look forward to your questions.

[The prepared statement of Mr. Ertel can be found on page 64 of the appendix.]

Chairman GARRETT. Thank you.

Next, Mr. Frank. Welcome. You are recognized for 5 minutes.

STATEMENT OF ALEXANDER C. FRANK, CHIEF FINANCIAL OFFICER, FIFTH STREET MANAGEMENT LLC

Mr. FRANK. Thank you. Good afternoon, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, and thank you for the opportunity to speak today. My name is Alex Frank. I am the CFO and a partner in Fifth Street Management, with over $3 billion in assets under management and the SEC-registered investment adviser of two publicly traded business development companies. Our team has a 15-year track record financing small and midsized companies, primarily in connection with investments by private equity sponsors.

BDCs like Fifth Street play an essential role in the new world of middle market lending. As traditional banks have pulled away from lending to small and midsized private businesses, alternative lenders like BDCs have filled the void, emerging as the primary conduit between banks and smaller companies that are noninvestment grade credits. Consider that 9 years ago, there were just four publicly traded BDCs. Today, there are roughly 10 times as many, and we estimate that within the next few years, BDC assets will exceed $100 billion.

Despite the growing importance of BDCs in helping finance small and midsized companies in our economy today, the BDC industry is still operating with legacy regulations that cost the industry significant amounts of time and money each year. Since BDCs are pass-through vehicles, that cost is borne not just by BDC shareholders, but by small businesses we serve.

Several aspects of H.R. 1800 and H.R. 31 could go a long way towards modernizing the BDC regulatory framework. Shell filing, incorporation by reference, and treating preferred equity as regulatory capital will bring parity to the industry vis-a-vis counterparts like REITs and MLPs. We also support allowing BDCs to own registered investment advisers as a shareholder-friendly step that would offer investors incremental fee-based revenue.

As you can see, I join you today as a proponent of the proposed rule changes in virtually their entirety. However, as the CFO of a conservatively managed investment grade BDC, and having spent 22 years working at Morgan Stanley, including serving as the firm's global treasurer, I cannot endorse the move to a 2:1 leverage ratio.

Today, the Securities and Exchange Commission does a highly effective job enforcing this leverage ratio. I believe the 1:1 ratio and strict SEC oversight contributes to a reputation for safety that is appreciated by both BDC investors and nationally recognized rating agencies alike. Permitting 2:1 leverage might compel investors to reevaluate the BDC model, and retail investors may not appreciate the higher level of risk they are taking. And as rating agencies adjust their models, downgrades could follow. Even those BDCs who adopt a more conservative approach could be penalized and a noninvestment grade credit rating would increase a BDC's cost of capital.

I would like to conclude my testimony with a discussion of effective leverage, which takes into account on a look-through basis leverage of the underlying assets in which a BDC invests. In other words, it is important to recognize that BDCs often provide expansion capital to their portfolio companies, which are often heavily leveraged themselves.

Effective leverage is an important concept because it shows the true risk in a BDC's balance sheet. Wells Fargo Securities estimates the BDC peer group average at 3.5 times equity. But the most highly leveraged BDCs have effective leverage ratio estimates over 5.5 times. If the bills are enacted in their current form, BDCs with already high levels of effective leverage could essentially double their effective leverage up to 11 times.

Not all BDCs are alike, and I am also not convinced that 1:1 leverage is precisely the right level. During this period of high growth and increasing small business reliance on BDCs, completely removing the safety rails should be reconsidered. Having reduced the amount of risk in the financial system by requiring banks to hold more capital to support the risks associated with lending to noninvestment grade companies, only to shift that risk to entities like BDCs already operating with less risk, could significantly undermine the long-term vision the bill set out to achieve.

Thank you, Chairman Garrett, Ranking Member Maloney, and members of the committee for allowing me to present my views on this critically important topic.

[The prepared statement of Mr. Frank can be found on page 104 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Mr. Wunderlich is now recognized, and welcome, for 5 minutes.

STATEMENT OF GARY K. WUNDERLICH, JR., CHIEF EXECUTIVE OFFICER, WUNDERLICH SECURITIES, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. WUNDERLICH. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to appear before you today to discuss various legislative proposals to promote capital formation and job creation. My name is Gary Wunderlich, and I am CEO of Wunderlich Securities. I am testifying today on behalf of the Securities Industry and Financial Markets Association.

Wunderlich Securities is an independent investment firm and full service broker-dealer headquartered in Memphis, Tennessee, with 28 offices in 16 States employing over 450 people. We provide a full range of financial services to retail and institutional clients, including investment banking, institutional sales, trading, and research.

So on behalf of SIFMA and its member firms, I am here to express our appreciation for this committee's dedication to a review of the environment for capital formation.

America's success depends on a vibrant financial system that provides access to capital and credit at a reasonable price, and regional firms, such as the one I founded 17 years ago, play an inte-

gral role in our financial services system, particularly to assist smaller issuers.

Turning to the legislative proposals before us today, I would like to begin by discussing our views of one area of capital formation that has been frequently debated over the past few years: The impact of decimalization on liquidity of small cap and midcap issuers. Many have suggested that the move to decimalization has contributed to lower levels of liquidity in those stocks and that along with other factors has impeded capital formation for those companies. This question has been posed in a variety of forums of late, including Chairman Garrett's recent roundtable, as well as the SEC roundtable on decimalization.

SIFMA and its members have also been engaged in an active dialogue about the impact of decimalization on small and midcap issuers, and we generally believe that a pilot program which widens quote increments for small and midcap issuers would increase trading liquidity in those securities.

SIFMA supports a carefully structured pilot designed with very clear metrics for determining success to increase liquidity in the small and midcap market and create a more fertile environment for small and emerging growth companies to access the public markets. We know that these companies can be an engine for economic growth, and Congressman Duffy is to be commended for considering new ways to incentivize interest in small cap issuers seeking growth.

While SIFMA is supportive of a pilot that explores how a wider tick size could benefit small cap issuers, we do oppose any pilot program that would restrict trading within the spread as the current discussion draft contemplates. Any restriction against trading inside the quoting increment would be an unprecedented alteration of market practice and would prevent broker-dealers from providing price improvement to retail investors and deter the commitment of capital for market-making activities.

With respect to market price, trading within the quoted spread has always been permitted. Before Reg NMS and before the establishment of the stock exchanges themselves, market participants have always been able to meet in the middle on a negotiation over price. Perhaps more importantly, a trading restriction would have a negative impact on Main Street savers and retail investors. A consensus of most every market structure discussion in recent months is that it has never been better to be a retail investor, as the options for routing trades have increased, and as a result trading costs have substantially decreased.

Just a few years ago, the SEC considered and rejected a trading restriction when it adopted the current penny-wide quoting increment, concluding that such price improvement benefits retail investors and is in the public interest. The SEC's conclusion that it is in the public interest to allow trading within the spread is as relevant in 2013 as it was in 2005.

Moving on, I would note that SIFMA supports efforts to modernize regulation of business development companies as contemplated in the three bills we are discussing here today to better enable BDCs to fulfill their mission. The BDC structure was created to promote public vehicles as a means to bring capital to small

and medium-sized businesses, and by regulation 70 percent of BDCs' investments must be in private and small cap companies.

BDCs offer a critical source of capital to eligible companies not met in today's environment by traditional lenders. In fact, Wunderlich Securities has supported the efforts of some 17 BDCs this year alone resulting in more than 1.3 billion in capital formation.

Further, Congressman Fincher's discussion draft, which would modify existing regulation of EGCs, is also laudable, and SIFMA supports each of the four provisions in the discussion draft. These modifications remove some technical inefficiencies to the JOBS Act on-ramp so as to reduce uncertainty in regulatory treatment and allow EGCs more flexibility to launch their offerings in a timely manner.

In conclusion, SIFMA welcomes your continued interest in supporting capital formation through appropriate regulatory relief. Many in government often try to distinguish Main Street from Wall Street, but the capital allocation function provided by my firm and thousands of others across this country supports the creation and expansion of tens of thousands of small businesses which are truly the backbone of our economy and the best hope we have for robust job creation moving forward.

Thank you for the opportunity to testify before you today, and I look forward to your questions.

[The prepared statement of Mr. Wunderlich can be found on page 174 of the appendix.]

Chairman GARRETT. Thank you for your testimony.

From the U.S. Chamber, Mr. Quaadman, welcome.

STATEMENT OF TOM QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee for the opportunity to testify before you today. I would also like to take this time to thank the subcommittee for its continued leadership in ensuring that the United States has the deepest and most efficient capital markets. And I think today's release of the crowdfunding rules by the SEC, albeit a lot later than I think a lot of us would have liked, is a testament to the leadership of this subcommittee.

A free enterprise system needs diverse capital markets. Capital is the fuel that drives our economic engine and different businesses have different financing needs. Filling those needs is a dynamic marketplace in response to an ever-changing economic, legal, and regulatory landscape. The 2008 financial crisis has had obvious impacts upon Main Street businesses.

To take one example out of Dodd-Frank, there is going to be a comment period that closes next week on credit risk retention, that if the rule is not properly implemented, collateralized loan obligations, which finance businesses to the tune of $300 billion, could no longer be an attractive form of capital formation. Basel III is having direct impacts on business lending by small and midsized banks, and Basel III also specifically disincentivizes the extension of commercial lines of credit by banks.

The bipartisan legislation that is being presented here today by the committee, which the Chamber supports, is keeping pace with those dynamic markets and is not lagging behind it.

Business development corporations are filling a void and are a growing source of financing for small and midsized businesses. As businesses are looking to be acquired rather than go public, the extension of reporting requirements and easing of reporting requirements for merger and acquisition brokers is key. The tick-size pilot program is an experiment to increase liquidity and look at regulatory innovations through factual evidence. The XBRL exemption, as well as security laws changes for emerging growth companies, are building upon the IPO on-ramp created by the JOBS Act.

However, we do have suggested improvements to these bills. With business development corporations, as has been stated before, they are close-ended funds that are open to retail investors and not just accredited investors, and they have higher yields, as well as higher risks. We believe that the SEC, in developing implementing regulations, should be directed to reexamine disclosures so that investors know what they are investing in.

With XBRL, we believe that the rule 406T grace period should be extended for 2 years for large issuers and 5 years for smaller issuers. We also believe that there should be a requirement for an annual SEC report to Congress on the SEC's progress on XBRL, the cost to businesses for XBRL implementation, the use of XBRL by investors, and that there should also be a report by the SEC to periodically report to Congress on the retrospective review of obsolete and unnecessary disclosures.

To give one example that I have in my testimony, one Federal agency, working under the auspices of President Obama's regulatory reform executive order, took 120 outdated regulations off the books on May 17th, and that was the Federal Communications Commission, some of those regulations dating back to the 1930s. With tick size, we believe that there should be a safe harbor from litigation so that as directors and management decide on a tick size, it is recognized that they are operating within their fiduciary duty for the best interests of the corporation and that they should not be subject to unnecessary litigation.

With emerging growth companies, we believe that Rule 701 should be modernized so that the dollar limit on private offerings may conform to the JOBS Act section 12(g) changes. So while the JOBS Act changed the number of investors that could be subject to private offerings, the $5 million limit that was put in place by the SEC in 1988 no longer is indicative of the market forces, so if you even just change that for inflation, that number today would be $10 billion.

There is a cost of inaction if these bills are not passed. If these bills are not passed, we will see continued economic underperformance, sluggish job growth, and business caution. If these bills are passed, combined with the implementation of the JOBS Act, we can break that cycle and stoke the smoldering engines of growth.

Thank you, Mr. Chairman. I am happy to take any questions you have.

[The prepared statement of Mr. Quaadman can be found on page 108 of the appendix.]

Chairman GARRETT. And I thank you, Mr. Quaadman.

And finally, Mr. Weild is recognized for 5 minutes. And welcome to the committee as well.

STATEMENT OF DAVID WEILD, FOUNDER, CHAIRMAN, AND CHIEF EXECUTIVE OFFICER, ISSUWORKS

Mr. WEILD. Thank you, Mr. Chairman. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for inviting me to speak today on legislation to further reduce impediments to capital formation. My name is David Weild. I am chairman and CEO of IssuWorks Holdings, which was recently founded to develop technologies to improve capital formation in the public markets. I was formerly vice chairman of the NASDAQ stock market with responsibility for all of its listed companies, and I ran the equity new issues business at Prudential Securities back when Prudential Securities was one of the 10 largest underwriters in the United States.

Improving access to equity capital in the United States is simply one of the most important needs for our economy. It fuels job growth and innovation, which in turn enables free markets to solve problems from poverty to unemployment to finding cures for cancer, global warming, and many of the other challenges that this generation and every other generation will face.

I would like to start by thanking you for the terrific bipartisan work that culminated with the signing into law of the JOBS Act on April 5th of 2012, but while the JOBS Act created the so-called on-ramps to facilitate companies getting public, it did nothing to improve the after-market for these companies and their investors. So one might legitimately ask, have we created the on-ramp to nowhere?

We are generally supportive of all of the bills in this group and our specific comments are contained in our written testimony. We have included other recommendations on capital formation and job growth in our written testimony and we hope that this committee will take it under advisement. However, I would like to focus on Mr. Duffy's bill because it speaks to after-market support, and without after-market support for small cap equities, the U.S. economy will languish.

Our listed stock markets are in the midst of a protracted collapse, and I call your attention to data which is contained in our statement that was recently compiled by the CFA Institute's Jason Voss. The United States today has fewer publicly listed companies than at any point since all the way back to 1975. In fact, we have fewer than 4,900 publicly listed companies. We have lost half of them from the markets. And we should have, if we hadn't done anything to market structure in the 1990s, closer to 13,000 publicly listed companies.

We published a study for the Organization of Economic Cooperation and Development in July, and in it we found that the United States has the lowest after-market incentives of any of the 26 largest IPO markets in the world. Very simply, we are starving our markets. Consumer activists who promote low-cost trading in stocks are promoting fool's gold. There is no free lunch. In fact, low-cost trading in illiquid stocks harms consumers by depriving them

of higher disposable incomes while wreaking havoc on the lowest socioeconomic classes of our society. It also seems obvious that the great growth companies of tomorrow, those very companies that will find the cure to Alzheimer's and global warming and advance the technologies for sourcing renewable energy, need a United States IPO market that is as vibrant as it used to be when companies like Intel, Microsoft, and Amgen went public. We are doing 135 IPOs since the end of the dot-com bubble. We were doing over 500 a year before the dot-com bubble, and on a GDP-weighted basis we should be doing closer to 900 IPOs a year today.

So we not only support this bill, we hope that this bill will, in addition to 5 and 10 cent tick-size increments within nano-cap stocks defined as stocks under $100 million in market value, consider a 20 cent tick option. The bill should require that trading be done only at a minimum tick-size increment, not within the tick size.

And I am going to take issue actually with the SIFMA testimony in this regard because much of that is a view that is proffered by dark pool interests with the larger firms. You have to be very careful not to gut the tick-size incentives and takeaway by allowing people to trade within the economic incentive and to actually take away the inventive for smaller firms to provide value, which is research, capital, commitment, and sales support to these stocks. There should also be no payment for water flow allowed that would make a mockery of the intent of this structure.

Higher after-market incentives through higher tick sizes will lead to more liquidity, which will bring more institutional investment, which will raise stock prices in smaller stocks, and lead to more IPOs and more job creation that will grow the U.S. economy. Today, there are already fewer than 3,700 operating companies in the Wilshire 5000 index.

So with this in mind, we urge Congress to come together and get behind this bill and give Americans an on-ramp to prosperity. Thank you, Mr. Chairman.

[The prepared statement of Mr. Weild can be found on page 154 of the appendix.]

Chairman GARRETT. And thank you for your testimony.

I welcome everyone, and thank you all for your testimony. At this point, we will turn to questions, and I will recognize myself for 5 minutes. I will just start with Mr. Abshure.

Do you see any benefits, either in jobs or benefits to the economy, for financial services investment companies, financial institutions?

Mr. ABSHURE. I guess I am—

Chairman GARRETT. I say that, because your opening comments were opposed to the legislation that is before us today that would expand for the asset classes the type of assets that they may invest in?

Mr. ABSHURE. The type of asset classes that BDCs could invest in.

Chairman GARRETT. Yes.

Mr. ABSHURE. Do I see a benefit of BDCs investing in financial services companies?

Chairman GARRETT. Do financial services companies not provide the economy with growth to the economy? Do they not provide the economy with new jobs and the like?

Mr. ABSHURE. They invest in companies that do that. But if you already have—

Chairman GARRETT. But they don't provide them jobs and what have you in amongst themselves?

Mr. ABSHURE. Not in the way that BDCs were designed. You have a carve-out specifically for BDCs that was designed for small companies, startup companies, and financially distressed companies. And then you have that mechanism for unaccredited investors to invest in those companies. Financial services are something different. And my point is, if you allow BDCs to invest in financial services companies that are, in turn, going to be a conduit for that capital to go somewhere else, you have just inserted a second step that provides no benefit but more cost. If BDCs can invest in what a financial services company can invest in, why do they need to be there?

Chairman GARRETT. Okay. I see your point. You are suggesting that we are not getting any benefits from those financial institutions in and amongst themselves. I would disagree with that.

Turning to the questions that Mr. Weild was talking about, you seem fairly passionate about the issue of the—I guess on the Duffy language and the trade-out rule. In your testimony, you said trading should be done only at the "outer bounds of minimum tick size increments, not within the tick increment." And you go on to say this may be controversial.

First, why do you say that may be controversial?

Mr. WEILD. We don't trade stocks, so we don't have a horse in this race. I can step back and I think be objective.

There are lots of interests right now that provide so-called price improvement to investors, a tenth of a penny, something that is relatively trivial. Large cap markets can perform very well because there are lots of buyers to offset sellers. There is a network effect. It is what academics will call symmetrical order book markets. But in small cap markets, which are asymmetrical—big buyer, no seller; big seller, no buyer—somebody has to provide value capital, and they have to provide salesmen to find the other side of the order. So you need an economic incentive to do that, and the minute they start trading within the tick size, the market devolves and it starts competing exclusively on price, so the whole thing starts to fall apart again.

So I don't think it will work, Chairman Garrett, in my view, and I think that if you give people a real nickel, and everybody trades, say at 10 by 1005, then what it will do is it will cause the firms to think about how to provide value to attract order flow, to create order flow, and it will start to bring capital into these micro-cap markets, lift them, which will then make them more attractive to move market IPOs into.

Chairman GARRETT. So if we do something along the lines of setting—I will open this to you and other members, Mr. Wunderlich, if you wanted to join in—if we do something along the lines of setting of a pilot program, are there ways to do it such that you could set up measurement matrices to actually measure what you are

talking about, and also measure liquidity in the marketplace on this?

Mr. WEILD. Sure. You could set up different baskets of stocks where you actually test where you have pull sanctity to the tick size, where you allow maybe even, it has been said trade at one price point within the tick size so that, for instance, if it was a nickel tick, you can trade at 2.5 cents, but that is it. And then, sort of the status quo. And you could test three buckets.

You have to be careful though because Wall Street sometimes can be very crafty and they can "paint the tape," to use an old term.

Chairman GARRETT. What do you mean?

Mr. WEILD. Meaning that you can have some interest that if you have a basket of 100 stocks, that if they want to demonstrate that there is more volume in one particular size, they may actually push volume through one pile, which could be very careful to control.

Chairman GARRETT. Yes, okay.

Mr. Wunderlich, do you want to join in on that?

Mr. WUNDERLICH. Our position, SIFMA's position is that there is value in the off-exchange pools and there is price improvement that we think is very demonstrable. Any restriction or prohibition on trading, on free market trading, we think would be a deterrent and distort actual market valuation and efficiency.

I can speak on behalf of Wunderlich Securities. In my firm, we are market makers. Our market-making activities have come way down from when decimalization was put in place. And a part of it is, so it is not, "Wall Street trying to make more money," it is managing risk. And so if I know now I have to trade at a nickel, or a dime, or even 20 cents, I am less likely to commit as much capital to market-making activities as I would if I knew that I could negotiate a price as a buyer and seller.

Mr. Weild is right in that it can be a somewhat inefficient market, certainly without market makers. There are large buyers at some times and a few sellers, and there are large sellers and sometimes a few buyers. And market-making activities which we would undertake are to facilitate those orders. We could potentially take one side of that trade in order to facilitate an order from a customer who had a position, whether buying or selling. But we are less likely to do that if we are being prohibited or restricted on how we can liquidate that position.

Chairman GARRETT. How you do the trade—yes? I can keep on going on this, but my time is up. And before I yield to the gentlelady from New York, I would just like to recognize the former chairman of the Financial Services Committee, who is not only looking at me in the face now, but is also looking over my shoulder as well, and welcome Chairman Oxley.

It is good to be with you again.

And of course I should point out that he is one of the reasons why I am even on this committee here in the position I am in today, so thank you for that as well, Mr. Chairman.

At that, I will yield to the gentlelady from New York.

Mrs. MALONEY. I likewise would like to recognize the gentleman who is literally on the wall, usually in the chairman's seat. It is

very good to see you again, Chairman Oxley. It is wonderful to see you.

I would like to start with Mr. Frank. You testified that basically, allowing BDCs to double their leverage would magnify the risk to shareholders, which are often retail investors. Mary Jo White, the Chair of the SEC, shares your concern in a letter that arrived today, and I would like to ask unanimous consent to make that letter a part of the record.

Chairman GARRETT. Without objection, and it should be indicated that this is a letter with which I am familiar. This is a letter from Ms. White in her individual capacity and not from the SEC.

Mrs. MALONEY. Right.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. MALONEY. Thank you.

And I would like to know, do any other panelists agree with Mr. Frank's position on this issue? Does anybody else agree with him? No one else does? Does anyone disagree with him, and would they like to give their position? Mr. Arougheti?

Mr. AROUGHETI. I would be happy to, for a counterpoint.

First of all, representing the BDC industry today, to my knowledge, I think Fifth Street is the only member of this growing industry who has come out in opposition of an increase in leverage or a change in the asset coverage ratio. I have difficulty reconciling that with the fact that they also signed a letter of support for the proposed legislation with a host of other industry participants that came from the SBIA to the SEC a couple of weeks ago.

In order to really understand this, I think it is important to just maybe take a step back and understand how the assets that BDCs invest in are already getting leveraged in the market and how the market participants are thinking about the increased risk.

First, I think it is also worth clarifying that about 40 percent of investors in BDC stocks today are sophisticated institutions and not retail, and it may be a misconception that retail investors are driving growth in the BDC space.

If you look at BDC balance sheets today, BDCs, depending on who you are, pursue different business models. Some BDCs invest in riskier mezzanine loans, which on their face are not leverageable due to their higher risk, and to use Mr. Frank's language, have a higher effective leverage and therefore will not command leverage at the portfolio level. Other BDCs, such as ourselves, pursue a less risky strategy focusing on senior secured loans, which by definition carry less risk and therefore can command greater leverage. So the idea of leverage of loan collateral is something that is well-documented and already in practice in the BDC space in the financial services industry generally.

To put a finer point on that, leverage in the BDC industry today is about 50 percent provided by banks. To use Ares as an example, we have about $2 billion of leverage that we get from the banking community, from notable lenders such as JPMorgan, Merrill Lynch, and Bank of America, et cetera, and we have 50 percent of our leverage that comes from the institutional debt markets.

If you drill down into how the underlying documents work for these loan agreements, you will see that there are actually borrowing bases that are already in place where the bank lending

community has assigned different risk to different asset classes that BDCs invest in, and based on that perception of risk have a willingness today, as does the institutional market, to either increase leverage on lower-risk assets or decrease leverage on higher-risk assets.

So I think the mechanisms are already in place. The overarching constraint is the regulatory restriction on leverage. So I don't believe that leverage in and of itself means increased risk. I think the markets have reached a level of complexity and sophistication today to handle the differentiation between low-risk assets and high-risk assets. I think to not allow a change in the asset coverage ratio flies in the face of the policy mandate that BDCs were created for today, which is to make sure that we can get capital to small companies and grow jobs.

Mrs. MALONEY. Mr. Abshure?

Mr. ABSHURE. I just wanted to make sure, apparently I didn't nod my head sufficiently vehemently enough. State securities regulators share the concerns voiced by both Mr. Frank and Chair White in her letter. However, I don't feel that I could put those concerns anywhere near as eloquently as Mr. Frank and Chair White did.

Mrs. MALONEY. Mr. Quaadman?

Mr. QUAADMAN. Ms. Maloney, I think one is the change in leverage from 1:1 to 2:1 is actually a modest change in leverage. If you look at a well-capitalized bank, obviously there are different companies, but a well-capitalized bank has a leverage ratio of 7 or 8 to 1. So one is, that change actually will allow BDCs to provide more liquidity. The SEC also has a number of different tools at its disposal to see if the BDC is acting properly, is being an appropriate, active participant. And that is also one of the reasons why we ask for more disclosures for investor protection.

Mrs. MALONEY. Mr. Chairman, my time has expired, but may I ask for a few seconds for Mr. Weild to respond? His hand was in the air.

Mr. WEILD. Thank you. We actually commented on this in our written testimony, and we just said that a higher leverage ratio my boost yields to investors and result in an increase in share price values. And we had actually called for some scenario analysis, some stress test analysis. Because these are already fairly highly leveraged businesses. It is the mezzanine debt finance market, debt plus warrants, and to understand in an inverted yield curve environment to where, in a deep recessionary environment how these portfolios are going to perform, I think would be only prudent. We are not averse to going to 1.5:1, but we would just like more information on how the portfolios would perform.

Mrs. MALONEY. My time has expired. Thank you.

Chairman GARRETT. All right. And I would just ask you to maybe provide us some measurement tools on how you would do that, how we would gather that information.

But with that, I will yield now to Mr. Hurt for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

I want to thank each of you for your testimony here today and for the work of our colleagues in trying to improve access to our capital markets.

My questions relate, as I said in my opening statement, to the XBRL. And I want to say how much I appreciate the useful comments made by the Chamber as it relates to this issue.

With that in mind, Mr. Quaadman, I was wondering if you could talk a little bit about what the benefits are of XBRL in the big picture? You point out in your testimony that perhaps a 2-year delay in the compliance might be a good idea. I am wondering, what are the benefits and how would a delay be consistent with those benefits?

Mr. QUAADMAN. Sure. There would be a number of different benefits with a delay. One is that XBRL is still a work in progress, and the whole theory behind XBRL is that you are going to move away from a paper-based system to a digital-based system, and then investors can pick and choose what information they want to analyze a company with.

The problem is the SEC has, quite frankly, had a number of different problems with getting this off the ground. Some of the exemptions that we are talking about actually allow companies that are in XBRL to furnish instead of file reports under XBRL, and that is important because if it is furnished there is no liability; if they are filed, there are.

So the reason why we are asking for a delay is, one, is to get the SEC's house in order, to get the system up and running as best as they can. The other issue, and this is the reason why we asked for reports, is it is also important for Congress and the SEC to know how exactly are investors using XBRL, are they using it or not, and currently they really aren't.

Mr. HURT. Right, and why is that?

Mr. QUAADMAN. Because they think there are a number of different sources that are out there that investors can use to access information if they like. It is available in a number of different sources and formats. Theoretically, if you can get them all in under XBRL at the SEC, it will make it easier. It will be one-stop shopping. That just hasn't existed. So it is sort of the savvy investor who knows where to find the information can get it now; others can't.

Mr. HURT. Okay. And you mentioned this, I think there is a study that shows that less than 10 percent of investors use the system at all.

Mr. QUAADMAN. That is correct.

Mr. HURT. And I think it must go without saying that there is already an obligation. To the extent that SEC should promote transparency, I think we would all agree that is one of the cornerstones of our capital markets and the SEC's fundamental mission.

But with that said, these issuers have that responsibility going forward. It is not like they can, without XBRL, somehow have some added incentive or added ability to hide information. Is that a fair statement?

Mr. QUAADMAN. That is correct. And the challenge that has existed, and there has been a frustration in the issuer community on this, the SEC has had a concept release out now for over 3 years on how to overhaul proxy plumbing systems. And this actually goes back to XBRL as well, because all of the systems in terms of how you report these issues, the disclosures, the corporate governance

issues, they are all rooted in a 1930s technology, and the SEC has sort of just allowed this to languish. So XBRL to some degree is a little bit of a symptom, but there is a disease out there, and we need to overhaul these systems into the 21st Century.

Mr. HURT. The Chair of the SEC has talked about disclosure overload. We think about the benefits and what we hope that XBRL will bring, or what the SEC hopes it will bring to the table, but there are real costs to this for issuers and potential issuers. That is what we have heard certainly through our work on this as we have talked to folks about this issue. Would you agree with that?

Mr. QUAADMAN. Yes. The disclosure overload harms both investors and issuers. So if you look at disclosures today, they are well over 100 pages and probably at least double what they were 15 years ago. And if you looked at disclosures in the 1950s, you could have had a concise report that was 6 pages long. So the problem is, it is more difficult for companies to communicate with their investors. The investors just have information dumped on them and it is difficult for them to sort through what they think is actually material or not.

And that actually gets to the core of the issue, is that the SEC—and this is what Chair White was also referencing in her speech—has moved away from what is material to investors. And the more we have moved away from that, the more inefficient the capital markets become. So we need to reorient the reports in a readable format, we need to make the information in there more material, and therefore there can be actual real communications between companies and their investors.

Mr. HURT. Excellent. Thank you for your answers. My time has expired.

Chairman GARRETT. The gentleman's time has expired.

The gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman, and thanks for this series of hearings because it is very important that we get capital, particularly to small business.

Without objection, I would like to enter into the record a letter from NAFCU, the National Association of Federal Credit Unions, dealing with the role that they can play in financing small businesses if we were to make a few changes in the laws regulating credit unions.

Chairman GARRETT. Without objection, it is so ordered.

Mr. SHERMAN. Previously entered into the record is a letter from the Chair of the SEC, and I would like to highlight on page 4 of that letter a statement that two of the bills, one of which would amend Section 60 and permit BDCs to purchase securities issued by registered investment advisers, and another one that would direct the Commission to revise certain rules under the Securities Act of 1933 to put BDCs on parity with other issuers that are required to file certain reports with the SEC under the 1934 Act. The chairman says that in her view these provisions do not raise significant investor protection concerns, so we should congratulate the authors of those two bills.

Mr. Frank, there are two possible changes dealing with BDCs that would increase the upside and downside risk to those who in-

vest in the common shares of the BDC. One would open the door to more issuance of preferred stock. The other would allow greater leverage. And I can see how you wouldn't want to harm the brand name of BDCs among retail investors. They are looking for a moderate level of risk and here is an opportunity to have more risk, both upside and downside.

Should we create a new designation, the high-leverage BDC, that would be allowed to get the benefit of those preferred share issuances and the higher leverage, and in that way just let investors know that you can invest in a regular, old-fashioned BDC or you can invest in the Ferrari that might crash? Would that solve the problem allowing some BDCs to go Ferrari style and some to be, what should I say, a Volvo with lots of air bags?

Mr. FRANK. No, I don't think it would. But first, I would just like to say that I think that allowing BDCs to include in their capital structure some level of preferred equity, which had the appropriate characteristics around capital permanence, is not something that we would think is necessarily imprudent and probably there is a place in the capital structure for that.

Mr. SHERMAN. But you would object to the idea of having high-leveraged BDCs identified as such, allowed to have different coverage ratios than regular BDCs? You would object to that?

Mr. FRANK. I would, yes. I think that would introduce a level of complexity in the industry that would—it is already a fairly complex structure for investors, particularly retail investors to understand, and I also think that—

Mr. SHERMAN. I have to reclaim my time because I have other questions on other issues. We are dealing with so many issues here.

Mr. Quaadman, XBRL software, why does it cost $20,000 per filing for even a small company to use that software?

Mr. QUAADMAN. I don't know the reason for why it costs that much. But—

Mr. SHERMAN. Excel is free.

Mr. QUAADMAN. I think you just made the point right there.

Mr. SHERMAN. Could the solution to this be to not exempt smaller companies from using it, but to make sure that the charge for using it is closer to $1,000 a filing rather than $20,000 a filing?

Mr. QUAADMAN. I would hope that with the length of time that can be done to get this right, we would have costs that are much more realistic. We need to go to some digital-based form of reporting, but we need to do it right and the SEC needs the time to get it right.

Mr. SHERMAN. So we might have a circumstance where we would delay a requirement due to the difficulty of government getting the computer technology right. That is interesting. Thank you.

Mr. QUAADMAN. Sure.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Yes, there we go. That is right.

Mr. Huizenga for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate that.

And I would like to kind of open it up on a couple of different fronts to a few of you. Under our existing system, there is a one-size-fits-all approach with SEC registration for the brokers, and I

am curious why you believe the SEC should be more tailored in its registration system for M&A brokers. I know Mr. Abshure and Mr. Ertel and a few others had talked specifically about our bill here.

But, Mr. Ertel, do you want to start off, maybe, and Mr. Abshure?

Mr. ERTEL. Having been through the process of getting the FINRA certifications to be a registered rep, they really bear little resemblance to the work that I do in helping a business owner get his business ready to sell, take it to market confidentially, sort through the various offers, and work with the various advisers to get that deal closed. So it poses an inordinately burdensome level of regulation on a transaction for which historically there have been very few bad actors, there have been very few cases where anybody has been injured.

Mr. HUIZENGA. And we have had testimony before this committee—Shane Hansen, whom I mentioned in my opening statement, Alliance of Merger and Acquisition Associates, I believe that you are advisers, you are familiar with him, he had said setup and compliance-related costs often exceed $150,000. I think you had said $150,000 to $250,000 in your testimony, correct? And then ongoing compliance often exceeding $75,000 per year. Talk a little bit about that impact for a smaller M&A person.

Mr. ERTEL. A lot of business brokerage firms and M&A advisory firms are very small shops—many sole practitioners, many firms of just two or three practitioners. So if you take that cost and spread it over the few transactions that they do a year, it is a very significant burden per transaction.

Mr. HUIZENGA. Mr. Abshure?

Mr. ABSHURE. Yes, I think if you go back and look at the historic definition of a broker under the securities laws, which is—and see that buy securities for its own account and for the—on the account of others, and you look at the existing system of regulation, both at the SEC and State level and also FINRA, you will learn that the system of regulation and the requirements is not really designed for the business in which an M&A broker engages. And I believe in your opening remarks you point—or perhaps Mr. Ertel pointed that out—that oftentimes an M&A deal, how it is structured is determined by the tax treatment. The M&A broker goes in, looks at the financial statements of the entity to be sold, helps clean that up, and makes some management advice. And then you get ready to do the deal, you look at the tax treatment, and decide whether it is an asset deal or a stock deal. If it is an asset deal, he is not a broker. If it is a stock deal, he is a broker. So it doesn't really make sense.

Mr. HUIZENGA. Even though that is the exact same transition and transaction, basically?

Mr. ABSHURE. True M&A brokers are business advisers that specialize in the business of advising a company that is looking to change management, is putting itself on the market. And as long as they stay within that narrow frame, I think that the States are fine with creating alternative registration and compliance systems for those.

The problem is that it is a very thin line between changing ownership and just selling a large block in connection with a capital-

raising transaction. So we would have concerns that the distinctions are clearly drawn.

Mr. HUIZENGA. All right. I have around a minute-and-a-half here. Under my bill, H.R. 2274, M&A is exempt from FINRA, while subject to some of these SEC rules relevant to the limited nature of what M&A broker activities are. But should FINRA regulate M&A brokers? Anybody care to comment on that?

Mr. ABSHURE. No.

Mr. HUIZENGA. Excellent. Okay.

Mr. ERTEL. I would agree.

Mr. HUIZENGA. I am curious why, if you want to elaborate.

Mr. ABSHURE. It goes back to why you are talking about exempting or changing the structure of M&A brokers. The entire FINRA system, regulatory system, is set up to govern brokers that are in the business of buying securities either for their own accounts or for the accounts of their client. That is not what these guys do. So there is no reason—and plus the numbers are so much smaller than what we are going to see from a regular broker-dealer standpoint—there is no reason, it would be extremely inefficient to set up a third level of regulation for business brokers considering the very narrow nature of their business.

Mr. HUIZENGA. This is government we are talking about, so there is not always a concern about efficiency. But there is from this member, and I know from many members of this committee. And ultimately, I will part on this, who ultimately bears the cost of the fees associated with registration and compliance associated for the M&A brokers? I think we probably all know the answer, but if anybody cares to jump in?

Mr. ERTEL. It ultimately passes through to the buyer and seller of the business. I have made the statement that if the deal was all cash and you marked the bills that were brought to closing, the buyer brings all the money and the broker takes home some of it. So a lot of it falls to the buyer. Some of it falls to the seller.

Mr. HUIZENGA. Right, thank you. My time has expired. I appreciate that. I just wish Mr. Hensarling was here, our Chairman Hensarling was here to hear again how important that this bill is. But I am glad he was here for opening statements. So, thank you.

Chairman GARRETT. Okay. The gentleman from Georgia is recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. This is certainly a fascinating hearing.

I have two lines of questions. First of all, it seems to me we are sort of turning the BDCs on their head here, and so I think it is important that the first question I want to ask is that by permitting the BDCs to invest all of these funds in financial firms instead of the nonfinancial small businesses, would not that divert capital from the small, growing businesses that the BDCs were originally created to help? Am I off base there? Do you all have any concerns that might be happening?

Mr. ABSHURE. The State securities regulators share your concern.

Mr. SCOTT. And I am also concerned about the fact of the other thing. Right now, it is prohibited in the hedge funds. And would BDCs and their allowing them to invest entirely in private funds,

including hedge funds, would not that allow the BDCs to circumvent the general prohibition on selling interest in private funds to retail investors?

Mr. ABSHURE. If you will recall, in my opening remarks I said that in the State securities regulators' opinion, the changes in the BDC laws that are being proposed would effectively allow hedge funds for unaccredited investors.

Mr. SCOTT. Okay, thank you. And would not this turning this on its head eliminate all of the provisions intended to protect preferred stock investors? Holders of preferred stock could find that dividends not paid during lower earnings periods are never paid, even if the BDC subsequently prospers. Is that not a true statement? Shouldn't we be concerned about that, that these investor protections would be lost here?

Mr. AROUGHETI. If I may, I think we may be talking about apples and oranges. And there was testimony introduced into the record by Prospect Capital around some of these issues. I think it is important to differentiate between finance companies and financial services companies. My understanding of the dialogue is in regard to traditional commercial finance structures such as equipment leasing companies, commercial finance companies, and franchise finance companies, all of whom occupy a very important role in the capital formation for small companies.

Under current regulations, BDCs are actually prohibited from investing in those types of businesses, and it is those types of businesses that are part of the formula for getting capital to small business. When we are talking about structures like private equity funds and hedge funds, to Mr. Abshure's point, I do think that could be worthy of further reflection and discussion insofar as those are fund structures, not operating companies. And I think it is important to make a very clear distinction between those two types of structures.

Mr. SCOTT. Okay. Now, let's go to the tick sizes. There is a tick size that is being advocated of 5 cents or 10 cents. There are even some who want the continuation of the 1 cent or the penny. So there is not a unified position in the community on what size this split should be, which there should be. So my point is, given that there are some who want 5, there are some who want 10, there are some who want a penny, and some even want less than that, my question is would it be appropriate to enshrine the tick sizes in the statute with this split and difference in your community?

Mr. WEILD. May I take a shot at that, Congressman? Any increase in tick sizes for small micro-cap stocks is going to be a step in the right direction. I think then it is a question of how we actually implement it. And I share this view with Professor James Angel from the University of Georgetown, who was a proponent of the issuer choice tick size model, because we think that what will happen is, by discussing what the appropriate tick size is with the securities firms, the investment banks, the value providers, and the institutional investors, that the companies will figure out an appropriate tick for the share price. A 5 cents tick size in a $10 share price is twice the value of a 5 cent tick size in a $20 share price.

So it is not going to be a one-size-fits-all. Where we came out was let the market decide, let individuals get into a discussion, and that

we would start to see liquidity bands and we would start to see individual ticks sort of gravitate to certain underlying liquidity bands as a result of market input.

Mr. SCOTT. One quick point and I am through, Mr. Chairman. But is everybody in agreement that a penny and a subpenny tick size is central to the decline of the U.S. IPO market over recent years?

Mr. QUAADMAN. Mr. Scott, if I could just take a stab at that. Number one, decimalization actually lowered costs for investors and actually provided for price discovery. What we are having now is a debate about whether or not, if you are going to have a pilot program on tick size changes, is that going to help drive liquidity to smaller issuers? So I think we need to differentiate different parts of the market from the other.

The other point to your first question is, I think it is important to leave it in the hands of the companies to decide, if there is a pilot program, decide what is best for the company, but then it is really going to be incumbent on the SEC to really research it in terms of, is it providing that liquidity to those companies, is it allowing people to look at smaller companies in a closer way than they are now, but also what is it doing in terms of cost to investors? So is it helping retail investors go to invest in smaller companies? What does it mean for mutual funds? Is it going to increase cost or lower cost for mutual funds? Is it going to have them become a bigger investor in smaller companies?

So I think the SEC, if there is a pilot program, needs to look at this holistically to see if this program is going to work, and then we should all come back and decide what the next step should be.

Mr. SCOTT. Thank you, Mr. Chairman, for that extra time. It was very helpful. Thank you.

Chairman GARRETT. Mr. Grimm?

Mr. GRIMM. Thank you, Mr. Chairman.

Mr. Arougheti, we are hearing a lot of different opinions on the role of BDCs and the impact that it could have. So I wanted to hone in on a few things regarding the kind of BDCs that you specialize in, like yours. What is their current ability, the kind of firms that BDCs like yours finance, the ones that you are providing capital to, what is their current ability to access capital to grow either via a bank or the other capital markets?

Mr. AROUGHETI. Thank you, Mr. Grimm. Maybe just to take a quick step back to understand the ecosystem that we operate in and to really understand the critical role that BDCs play, if you think about the traditional financing alternatives available to a small and growing company, there are community banks and local banks that can meet the needs of small businesses as they grow, with government subsidy or without government subsidy. However, they are limited in the flexibility of their product. Oftentimes, they are limited in their risk tolerance. Many times, they are limited in the size of capital commitment that they can give to a growing company.

So the BDC industry really begins to become relevant at the point in which the needs of a small and growing business outgrow the traditional small company alternatives, and we grow with that business all the way up to the point at which they can access the

debt or equity capital markets. That goes hand in hand with the policy mandate that we provide strategic and managerial assistance to these companies. So one of the ways I have always thought about BDCs, and it is inherent in the growth in the industry, is we effectively grow with these companies as they graduate through the capital markets ecosystem.

When you look at the type of companies that we lend to, we will lend to venture companies that are investing pre-revenue and pre-cash flow in new technology and innovation, all the way up to more mature companies. But the borrowers that find their way to the BDC space find their way to us for a reason, because their needs are being unmet by traditional alternatives.

Mr. GRIMM. And right now, just approximately last year, say, how many in loans did you provide capital for?

Mr. AROUGHETI. Ares is the largest industry participant, and we committed about $4 billion in new capital into the middle market.

Mr. GRIMM. And if this bill were to pass and the leverage ratio was increased, which I think is a very modest increase, from $1 to $2, how much do you think you would be able to increase your capability of loaning money to these small and midsized firms?

Mr. AROUGHETI. Significantly, and it goes back to my prior commentary. I think the increase in leverage will actually encourage BDCs to seek out lower-risk borrowers in a part of the ecosystem that they currently can't serve. When you look at the BDC structure as a pass-through entity, the yield requirement on BDC dividends for the more conservative players like us is 8 percent, and some of the "riskier players" the market is already differentiating with yields in excess of 11 or 12 percent. My expectation is that with a modest increase in leverage you would see the ability of BDCs to further meet the needs and serve the needs of their existing customer base.

I would also highlight, if I may, if you look at the SBIC debenture program, which has been very successful and is a very good indicator of the underlying performance of these types of loans, to put that in perspective, in Fiscal Year 2012, the SBIC debenture program extended about $3.1 billion in loans, and I would highlight that the SBIC debenture program currently allows for leverage of 2:1, consistent with the proposed legislation, as opposed to the 1:1 under the existing BDC regulation.

Mr. GRIMM. I apologize. I really want to get this in with 1 minute left, so please be as concise as you can because I think this is important. What level of losses would a BDC like yours need to experience to wipe out its equity at these ratios, the proposed ratios?

Mr. AROUGHETI. Commissioner White had in her letter a description of increased risk, saying that the loss rate would have to go from 50 percent to 33.3 percent to harm BDC shareholders. I think it is worth pointing out that the BDC industry over the last 10 years has experienced actual realized loss rates of about 60 basis points and some of the more conservative structures like Ares have actually had positive realizations, i.e., no net losses. So as we come off of the experience of the great recession and see how these middle market companies and this middle market collateral have performed, I struggle to craft a scenario where we—

Mr. GRIMM. Did any BDCs fail in the 2008 crises because of too much leverage?

Mr. AROUGHETI. There have been no BDCs that have failed or gone bankrupt.

Mr. GRIMM. Thank you. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Foster is now recognized.

Mr. FOSTER. Thank you, Mr. Chairman.

In Mr. Abshure's testimony he notes that one of his concerns with the BDC bills is the proposal that would allow them to invest in investment adviser firms. And his concern was that it might create a potential conflict of interest for the investment advisers to recommend to their clients that they invest in the BDC or their portfolio companies. And I was wondering if any of the other witnesses have a comment on this potential conflict-of-interest concern?

Mr. QUAADMAN. I would just add, I think that is one of the issues that the SEC can look at. I think that is what Mr. Sherman was sort of driving at, is that if you go forward with this legislation, you allow them to become bigger liquidity providers in the market and you provide for more investor protections, if you know that there are different types of strategies that are involved, the SEC has the tools, through stress tests and others, to see if they are acting appropriately and the like. So I think there are ways to monitor that and then to come back and see if more needs to be done.

Mr. FOSTER. Is anyone willing to venture a guess as to what fraction of BDC holdings might be expected to flow into investment advisers if the restrictions are lifted? Is this going to be a little pimple on the whole industry or does this have the potential to be a dominant component? Any feeling at all? All right.

If I can move to tick size, would it be a good idea if the tick-size experiments were conducted both with and without bans on trading between the ticks? Is that an interesting element of the pilot proposals? Because there is sort of a different opinion as to how big an effect that would be and whether it would effectively vitiate the tick-size proposals.

Mr. WEILD. I think that was a recommendation we made way back at the February 5th roundtable on decimalization, and if you really want to create a pilot you can segregate different groups of stocks and you can extract interesting comparable information.

Mr. Wunderlich's comment, I agree and I don't agree with the comment about market makers, risk taking. There are 53 different trading venues in the United States now so markets are structurally very different from the days when we had over-the-counter market makers, when we did control risk by essentially being able to put stock out within the bid and the ask side of the market. So it is not clear that is actually going to be the way that market makers control risk today given that a dark pool might siphon off just mounds and mounds of liquidity as investors are searching out lowest possible price as opposed to value provision.

I just honestly think we have to get started and try some stuff and we have to keep doing it and keep trying it because the problems are so extreme and the impact on the economy is so extreme that the upside for the American people is extraordinary. And so

we may not get it right the first shot, but doesn't mean that we don't take a second or third shot at getting it right.

Mr. FOSTER. Is it anticipated that the tick-size changes would result primarily in changes in the amount of technical trading or research-based trading or sales commission-based trading? And which is the kind of trading and liquidity that you are trying to encourage here?

Mr. WEILD. Real liquidity is when there is no order and somebody goes out and creates an order to offset a buyer or offset a seller. And that usually takes human beings to do. Machines don't do that. And there has to be an economic model to incent somebody to get on the phone. Right now there is no economic model to do that.

Mr. FOSTER. But that could be based on a statistical analysis of previous price points, which I would consider to be technical trading, or based on actually a study of the fundamentals of the company. And I am just trying to figure out which one you are trying to incent mainly, or which will you end up incenting mainly with the tick-size changes.

Mr. WEILD. We would be incenting real brokers, human beings, talking to institutional investors or retail investors about stocks and creating visibility in those names, in those stocks, which is activity for the most part which is going out of the market today.

We would also hope to be incenting capital commitment to facilitate the positioning of a block of stock before they find a buyer that is real liquidity on the other side for that block of stock. So we would expect that if these pilots were structured appropriately that one of the metrics you would look at is block liquidity. If block liquidity starts to go up 5,000 shares—right now things are put through the electronic mixmaster and you are looking at 100-share, 150-share trades ad nauseam, and if you start seeing the numbers creep up in terms of size of the trade, I think that is a sign that this system is having its intended effect.

Mr. FOSTER. Right. Thank you. My time is up. I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Duffy is recognized for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman. And again, I appreciate all of the conversation around tick sizes and maybe the benefits or drawbacks that you guys all have provided your opinions on.

First, I want to thank Mr. Quaadman for bringing up the issue of a safe harbor. I think that is a good point. If we are going to have a successful tick-size pilot program, we want to make sure there is no liability. And I think that is a conversation we want to pursue. But I appreciate you bringing that point up.

And I want to be clear, we don't have any interest, I am not trying to engage in the larger argument between our dark pools and exchanges, and I think we have entered into a space that has some people excited. We truly are trying to create more liquidity for small cap companies. That is the true intent here. And I know that people are looking down the road and it might take some signaling of our proposal that we are trying to have a greater impact on a market structure, and that is not the intent.

But maybe to Mr. Wunderlich, if we allow just a quote at, aren't we really undermining the purpose of a tick-size bill? We don't get the full impact of this experiment, this pilot program?

Mr. WUNDERLICH. Yes and no, in that it does seem sort of counterintuitive, right, that you are going to quote it in nickels and dimes and then you are going to trade it maybe in between. So maybe it does seem a little counterintuitive. But the issue, it is sort of, I guess, I would go back to a point in history when we tried to do it in 8ths and 16ths. We always traded between the bid and the ask. It has been done historically. And I think liquidity in our experience was a lot better before decimalization in small and midcap stocks; not necessarily the case in larger cap stocks.

The other issue is, from where I sit from a market-making standpoint we do think that it is taking more risk if you are committing to basically having to trade in larger increments. And the other side it is just sort of market valuation and efficiency. Markets, liquid markets are very efficient over time as far as where things should or shouldn't be priced. And I don't want to say it is manipulation or price fixing, but in a sense you kind of are, if you are mandating you have to be at this dime or this nickel or 20 cents.

That being said, I will reiterate, we are for the pilot, again, but we think we ought to be able to trade between the bid and the ask.

Mr. DUFFY. And we are creating a financial incentive here, aren't we? That is the purpose.

Mr. WUNDERLICH. I'm sorry, I didn't hear you.

Mr. DUFFY. We are trying to create a financial incentive here.

Mr. WUNDERLICH. That is correct.

Mr. DUFFY. And that incentive may be diminished if we allow more price improvement, trading between the ticks. Yes?

Mr. WUNDERLICH. No, sir. I think I would go the other way. The incentive is for whom? Right? Is it for the investor or is it for the brokerage firm, is it for the issuer? There are several constituents involved. And one is for us to have an incentive to even traffic in these stocks. And if we view that to an outsized business risk where we are mandated to have to take a price, then we are less likely to commit capital to something like that than if we were able to trade freely between the bid and the offer. Did that answer your question?

Mr. DUFFY. Kind of. Maybe we can talk about it a little more later.

Mr. Weild, do you agree with that? Do you think we diminish the pilot program, our tick-size pilot program if we allow trading between the ticks?

Mr. WEILD. I think we do on the margin. Step back for a second and look at the study that we did on the 26 foreign IPO market, the 26 largest. And we have a convention in this country where we don't allow—most brokerage firms don't allow brokers to solicit stocks or put them on margin if they are under $5 a share. So it arbitrarily keeps our stock prices high. So the United States has zero stock, zero percent stocks that have a 1 percent or higher tick size that are sub-500 million that are micro-cap or smaller, whereas the high IPO-producing countries, which are countries like Singapore, Australia, Canada, weighted for GDP, 70 percent or more of their micro-cap stocks have 1 percent or higher tick sizes

because they split the stocks down to levels where a penny, at 50 cents, a penny can make 2 percent difference incentive.

I do believe that a nickel or a dime and having some integrity to the tick size will ultimately cause the market to compete on providing sales, capital, value support, and it won't let the market compete on price, which is the problem in micro-cap markets.

I totally agree with the point of view, I think Tom said this earlier, large cap stocks that are innately liquid stocks actually become more liquid with smaller tick sizes, but the academic literature clearly shows that innately illiquid stocks become less liquid with smaller tick sizes. So the reverse of that, which is increase the tick and respect the tick size, will bring liquidity to these stocks.

Mr. DUFFY. And, Mr. Wunderlich, do you agree with that?

Mr. WUNDERLICH. Yes, I do.

Mr. DUFFY. Thank you, I yield back.

Chairman GARRETT. The gentleman yields back.

For the last word, Mr. Carney is recognized.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you for holding the hearing today. Thank you to all the witnesses. I have been working with Mr. Duffy on this tick-size issue, so I have been listening very carefully to the discussion over the last three questioners.

And our objective is pretty simple, Mr. Duffy laid it out, is to drive more liquidity, more activity to the smaller cap companies. And do I interpret everybody to say that you are for a pilot of some kind. Mr. Wunderlich? Mr. Quaadman? The last three had the most discussion, right?

Mr. WUNDERLICH. Yes.

Mr. CARNEY. So the question is, how to get it right. I was interested in the suggestion that Mr. Foster had about having both maybe a quote at and trade at provision in the pilot. Does that make sense? I will start with you, Mr. Wunderlich. You have a problem with our current approach, so what about the approach of having both?

Mr. WUNDERLICH. Clearly, and let me speak for myself and maybe not SIFMA here—

Mr. CARNEY. Sure, sure.

Mr. WUNDERLICH. I will speak for SIFMA in this regard. One, we need to have very clear metrics. And I think Mr. Weild said earlier, we want to make sure that if you do something on it, we want to compare apples to apples, and it needs to be very clear.

Mr. CARNEY. And by the way, that is my last question, and that would be the metrics in terms of the evaluation of this pilot. So to the extent that you independently can provide us with something in writing about what they ought to be, you have mentioned some of those, that would be much appreciated. Please.

Mr. WUNDERLICH. And now I have forgotten your question. I apologize.

Mr. CARNEY. The question was, the pilot that included both a quote at and a trade at, so that you have two different looks at trading within the spread.

Mr. WUNDERLICH. And I will speak for myself and Wunderlich Securities severally. I do believe that being able to trade between

the bid and the—between tick sizes would be better. That being said, ultimately, I am for a pilot in some way, shape, or form. And if it means having two pilots then I would be personally, and I will speak for myself and Wunderlich Securities here, I would be for that, versus not having a pilot at all.

Mr. CARNEY. Okay.

Mr. Quaadman, do you have a view of that?

Mr. QUAADMAN. Let me take it in reverse order.

Mr. CARNEY. Sure.

Mr. QUAADMAN. We are supportive of a pilot program. We think there needs to be exhaustive metrics on that.

Mr. CARNEY. And you have a view of what things ought to be?

Mr. QUAADMAN. Yes. We will work with both you and Mr. Duffy on that.

As to your last point, I think there is some attraction to that, and I want to think about that some more and get back to both you and Mr. Duffy on that.

Mr. CARNEY. Okay, sure.

Mr. Weild, do you want to take both of those pieces?

Mr. WEILD. We have done some work already on what we think the metrics should be. There is also a committee that has been advising Treasury, an ad hoc committee that includes some institutional investors that has done some work. So let me pull that together and I will just get it back to you on what we think metrics should be.

Clearly, the things that require people investments, on a short-term pilot people are not going to make long-term investments in research and things like that, but when you look at the trading characteristics, you will get a sense, I think pretty quickly with the right metrics, whether or not it is working. And so, I think this is eminently—

Mr. CARNEY. So we have a duration in the bill. Any comment on the duration? A 5-year duration is too long, too short, about right?

Mr. WEILD. I think longer is better, and then if it proves to be working, then just make it permanent. Because the problem with a short-term pilot is people might game it. If it is a 1-year pilot, which I think has been recommended in some circles, like in the Citigroup article that came out in the Wall Street Journal today, I think they recommended a year, I think that is too short.

Mr. CARNEY. Mr. Quaadman, you look like—

Mr. QUAADMAN. I think a 5-year pilot is fine, but I would recommend that the SEC come out with some interim report either at 2 or 3 years so you get a snapshot early on.

Mr. CARNEY. Any comment on the definition of companies that would be eligible either in terms of total cap size or other? Right now the definition pretty much tracks the emerging growth company definition in the JOBS Act, I believe. So is that too limited, too expansive? Any comments on that?

Mr. QUAADMAN. No, I actually think that is the right way to go, because that is a defined universe that Congress has already picked out, and it makes sense to go with that universe for this pilot program.

Mr. CARNEY. Okay. Are there other comments?

Mr. WUNDERLICH. I would agree.

Mr. WEILD. We would agree. I would also in our testimony, page 11, just call your attention to just show you, if you just use this one metric, sub-$2 billion market value companies, they only represent 6.6 percent of total market value. Said another way, you could trade yourself silly in the large cap markets, and that is the vast majority of market value, and these small stocks are just fundamentally different. About 81.1 percent of all listed companies are sub-$2 billion in market value, the institutional definition of small cap, and they represent only 6.6 percent of aggregate market value. You are comparing apples to oranges structurally. So, EGC definition is fine, gets to the same, close to the same place.

Mr. CARNEY. I want to thank each of you for your help, and your testimony today, and I thank my colleague from the other side. I yield back.

Chairman GARRETT. The gentleman yields back.

And we have been joined by Mr. Mulvaney for the last questions.

Mr. MULVANEY. Mr. Chairman, I apologize to both you and the panel for having to run back out and back in. It has just been that kind of day.

Mr. Abshure, I was here for your testimony, but I was not here for some of the follow-up questions. But as I understand it, you have a difficulty with retail investors being exposed to investments in hedge funds and private equity. Is that correct, sir?

Mr. ABSHURE. Yes.

Mr. MULVANEY. Okay. And I guess in theory I can sympathize with that a little bit, but don't pension funds face the same issue? And aren't there other instruments out there already that expose retail investors to investments in hedge funds and private equity funds?

Mr. ABSHURE. I don't think so on the levels that you are talking about here. You are talking about unaccredited, unsophisticated investors having access.

Mr. MULVANEY. Unaccredited, unsophisticated investors. Does that not describe most pensioners who work for CalPERS?

Mr. ABSHURE. Sure.

Mr. MULVANEY. Don't they invest in hedge funds and private equity funds?

Mr. ABSHURE. No.

Mr. MULVANEY. They don't? Pensions funds don't invest in hedge funds and private equity funds?

Mr. ABSHURE. No. Unaccredited investors can invest in pension funds, but unaccredited investors cannot invest in hedge funds.

Mr. MULVANEY. Okay. Don't the managers of both of those types of entities, of pension funds—

Mr. ABSHURE. The difference is you have a manager.

Mr. MULVANEY. I'm sorry?

Mr. ABSHURE. The difference is you have a manager in a pension fund as opposed to an unaccredited or an unsophisticated investor deciding to invest in the BDC all on his own, and then that BDC making decisions.

Mr. MULVANEY. I have never invested in a BDC. I have invested in a closed-end mutual fund before and it was readily apparent to me what the closed-end mutual fund had invested in. Is that same information available to somebody who invests in a BDC? If I want

to know what they are investing in before I buy a share of a BDC, do I get to know what they are investing the money in?

Mr. ABSHURE. No.

Mr. MULVANEY. That is a secret.

Mr. ABSHURE. I don't think a registered BDC is going to disclose all of its investment on the front end—

Mr. MULVANEY. Mr. Arougheti, help me out here. Do you tell your investors what you invest in?

Mr. AROUGHETI. Just a minor correction. By regulation, BDCs are required to have a detailed investment listing of every single security and investment.

Mr. MULVANEY. Okay. That is not a minor clarification. That is the exact opposite of what Mr. Abshure just said.

Mr. AROUGHETI. No, every quarter BDCs, by regulation, are required to provide a detailed investment listing by security that they hold on their balance sheet.

Mr. MULVANEY. Okay, Mr. Abshure, so is he wrong?

Mr. ABSHURE. No. You provide that every quarter after the purchase has been made, correct?

Mr. MULVANEY. Go ahead. You can respond, Mr. Arougheti.

Mr. AROUGHETI. Correct. We have full transparency as to what resides—

Mr. ABSHURE. So if I am a BDC owner on January 1st, I am going to learn what you did with my money at the end of that quarter.

Mr. MULVANEY. But you are also going to know on the day that you purchased the stock where that money is invested, correct?

Mr. ABSHURE. But in terms of what happens on day number 2 then, I will know at the end of the quarter.

Mr. MULVANEY. I didn't stay in the State government long enough to participate in that State pension, but a lot of my friends have. I have teachers in the South Carolina retirement system. How are they treated any differently than your hypothetical BDC investor? Do they know when they put money away for their pension where that money is going on a daily basis or do they get regular updates?

Mr. ABSHURE. No.

Mr. MULVANEY. They don't know, do they? There is no difference here. I guess what I am trying to get at is, why would we treat BDCs any different from pensions when it comes to hedge funds and private equity funds?

Mr. ABSHURE. I think there are many differences between BDCs and pension funds.

Mr. MULVANEY. And I am asking you for some of them.

Mr. ABSHURE. I think just the entire structure, the entire goal behind the pension funds, the required payouts of the pension funds, the way that pension funds are structured to provide payments over time, the way that pension funds are constantly monitored to make sure that they have assets to meet the payout responsibilities.

Mr. MULVANEY. And there is another difference, which is a lot of times, for example, if I am a teacher in South Carolina I don't even get the choice to participate or not, I have to participate. So

there are actually certain areas where it is actually worse to be in a pension.

Let me ask you this, because the SEC raised similar questions. I think it was a lot more well-articulated than what we have been through today. But, Mr. Arougheti, aren't there ways to handle this? That is really the concern. If there is legitimate concern that you don't want to end up with these entities being pass-through entities to simply fund hedge funds, aren't there ways to deal with that?

Mr. AROUGHETI. Yes, Mr. Mulvaney. I apologize, in prior commentary I thought that it was worth making the distinction between finance companies and funds. And as I said earlier, I do believe that there are parts of the financial ecosystem—leasing companies, franchise finance companies, et cetera—that are a valuable provider of capital, that are very distinct in the way that they operate and bring capital than the hedge funds and private equity funds.

Mr. MULVANEY. So to the extent Mr. Abshure's questions are legitimate, let's assume for the sake of discussion that they are, we can fix that, can't we?

Mr. ABSHURE. Absolutely.

Mr. MULVANEY. Thank you.

I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back. And I think that was the last word.

So at this point I want to, again, thank you all on the panel. And I ask unanimous consent to put 3 letters into the record from the Financial Services Roundtable, Reflexite, and Prospect, and also from SBIA. They are letters with regard to today's hearing, so they are put into the record. Without objection, it is so ordered.

Now, I can say thank you all for coming and for your testimony, which has been very illuminating and educational. And if we had any questions that we threw out to you that we didn't get back, we would appreciate you responding in writing for the record.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

So with that, I again thank you all. And this committee is hereby adjourned.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]

A P P E N D I X

October 23, 2013

Testimony of A. Heath Abshure

Arkansas Securities Commissioner

and

Immediate Past-President of the North American Securities Administrators Association, Inc.

Before the

House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislation to Further Reduce Impediments to Capital Formation"

October 23, 2013

Washington, DC

Introduction:

Good morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee, I'm Heath Abshure, Securities Commissioner for the State of Arkansas. Until earlier this month, I was also the President of the North American Securities Administrators Association, Inc. ("NASAA"),[1] the association of state and provincial securities regulators.

Prior to serving as NASAA president, I served as the chairman of both NASAA's Special Committee on Small Business Capital Formation, and NASAA's Corporation Finance Section. In addition, since 2011, I have served as an observer member of the SEC's Advisory Committee on Small and Emerging Companies, which has recently considered many of the same questions that will be examined at the hearing today.

I, personally, have a deep interest in issues related to small business finance and capital formation, and I am honored to testify for a second time before this Subcommittee about these issues.

Securities regulation is a complementary regime of both state and federal securities laws, and the states work closely together to uncover and prosecute securities law violators. State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. State securities regulators continue to focus on protecting retail investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your states are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents.[2]

Ten of my colleagues are appointed by state Secretaries of State, five are under the jurisdiction of their states' Attorneys General. Some, like me, are appointed by their Governors and Cabinet officials. Others, work for independent commissions or boards.

In addition to serving as the "cops on the beat" and the first line of defense against fraud for "mom and pop" investors, state securities regulators serve as the primary

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] States are also the undisputed leaders in criminal prosecutions of securities violators. In 2012 alone, state securities regulators conducted nearly 6,000 investigations, leading to nearly 2,500 enforcement actions, including 339 criminal actions. Moreover, in 2012, 4,300 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action, up 28 percent from the previous year.

regulators of most small company securities offerings. As such, state securities regulators regularly work with and assist local businesses seeking capital to grow their companies.

The states are committed to fostering responsible capital formation which in turn strengthens investor confidence and leads to job growth. At the same time, and as I testified to the Subcommittee in 2011, capital formation will be impeded when investors are not adequately protected.

Advisory Committee on Small and Emerging Companies

For over two years, I have had the privilege of serving as NASAA's designated member of the SEC Advisory Committee on Small and Emerging Companies ("Advisory Committee").

The Advisory Committee was established on Oct. 4, 2011, for a term of two years, and reauthorized for a second term earlier this month. Since the Committee was established, it has provided recommendations to the Commission regarding rules, regulations, and policies related to emerging companies, capital raising through private placements and public securities offerings, and reporting requirements for small and emerging publicly traded companies.

Some of the policies enacted last year by the JOBS Act were based on recommendations of the Advisory Committee. In 2011, I testified before this Subcommittee and expressed concern about many of the policies in the JOBS Act, including legislation that directed the SEC to lift the ban on general solicitation in private securities offerings, and to implement rules to legalize "equity" crowdfunding.

I remain deeply concerned that some of the policies enacted under the JOBS Act, including in particular, the lifting of the ban on general solicitation in Regulation D, Rule 506 offerings, will be detrimental to investors and ultimately to the companies that rely on this method of capital formation.

The SEC is currently considering a number of proposed amendments to the general solicitation rule adopted in July pursuant to Section 201 of the JOBS Act. NASAA strongly supports these proposed amendments.[3] It will be essential that the Commission move swiftly to adopt many of these proposed amendments, especially the proposed requirement that "Form D" be filed prior to the first sale that occurs in any Regulation D offering that uses general solicitation.

[3] See NASAA Comments in Response to Release Nos. 33-9416, 34-69960, IC- 30595 (File No. S7-06-13), "Amendments to Regulation D, Form D and Rule 156 under the Securities Act." 27 September, 2013. Accessible at: http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf

Overview of NASAA Perspective on Today's Legislation

Today, the Subcommittee is considering a number of new bills related to capital formation.[4] These include proposals to (i) streamline registration requirements of so-called "merger and acquisition brokers;" (ii) further ease reporting requirements applicable to "Emerging Growth Companies" or EGCs; (iii) and relax portfolio strictures, leverage limits, and other regulations for business development companies (BDCs). They also include common-sense proposals to reduce "red tape" that adds to the compliance costs of small and startup businesses, such as the SEC's requirement that certain filings be made using eXtensible Business Reporting Language (XBRL).[5]

NASAA's view regarding this new collection of bills is mixed. NASAA supports a number of these proposals; especially the proposed Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013 sponsored by Congressman Huizenga, but has concerns with other legislation pending before the Committee today. Most notably, NASAA is troubled by the proposal to further expand what are basically new, untested regulatory carve-outs for EGCs as well as proposals that would increase leverage and conflicts of interests in the BDC space. There are some bills before the Subcommittee on which NASAA does not have a strong stakeholder interest. For those bills, I will simply offer my own personal observations based on discussions I have had with others as part of my work on the Advisory Committee. Insofar as that latter category of bills does not pertain directly to state securities regulation, NASAA neither supports nor opposes their enactment.

<u>Streamlining Registration for Mergers & Acquisitions Brokers</u>

State securities administrators generally support the targeted, well-balanced provisions of H.R. 2274, the Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013, H.R. 2274. This legislation would establish a simplified and streamlined registration process for broker-dealers engaged solely in the business of effecting the transfer or sale of privately held companies (i.e., "M&A brokers"). NASAA is optimistic that this legislation will encourage registration and regulatory compliance by M&A brokers.

The registration process is an integral part of an overall regulatory regime at the state and federal level that is designed to promote responsible business practices among broker-dealers and to help protect investors. Generally, broker-dealers engage in the buying and selling of securities either for their own account or for the accounts of others. Broker-dealers may also engage in other businesses such as underwriting securities

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[4] At least one of the discussion draft bills before the Subcommittee is modeled on a recommendation of the Advisory Committee. See U.S. Securities and Exchange Commission. Advisory Committee on Small and Emerging Companies. Recommendations Regarding Trading Spreads for Smaller Exchange-Listed Companies. February 1, 2013. Accessible at http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-spread-tick-size.pdf

[5] While NASAA is supportive of reasonable statutory or regulatory forbearance for compliance with XBRL requirements for small businesses, as explained elsewhere in this testimony, we consider that the $1 billion annual revenue threshold contemplated by the discussion draft is far too high.

offerings and the making of markets for new and emerging companies. The current registration process is well suited to the vast majority of these broker-dealers. However, these registration requirements may not be as well suited to a limited number of broker-dealers engaged exclusively in the business of mergers and acquisitions (M&A Firms).

M&A Firms, as defined in H.R. 2274, would be limited to those firms engaged solely in the business of affecting the transfer of ownership of certain eligible privately held companies. As a result, the traditional registration process for broker-dealers is not particularly well suited for the M&A Firms. Furthermore, individuals who work for these firms and earn commission-based compensation in M&A deals have the additional burden of affiliating with a registered broker-dealer firm in order to obtain registration. The expense and compliance with the registration requirements has led many M&A firms, particularly those handling small M&A deals where firms typically pass on the cost of regulatory compliance to their clients, to forego registration and compliance requirements altogether. There is no public record of these unregistered firms or individuals, or the fees they earn for their services. There is no regulatory body (whether a government regulator or a self-regulatory organization) confirming that clients receive appropriate disclosures such as conflicts of interest and a list of employees and affiliates.

Investor protection is best served when regulatory necessity and transparency is balanced sensibly with the practicalities inherent in any business model. In the case of M&A brokers, H.R. 2274 strikes an appropriate balance. The bill reduces the standard regulatory requirements applicable to traditional broker-dealer firms and provides M&A brokers of privately held companies (as defined therein) with a simplified registration regime that provides sufficient oversight to these firms without diminishing the authority of state or federal regulators.

The M&A industry has worked with NASAA in developing the proposal that is contained in H.R. 2274. We welcome its introduction and look forward to supporting the legislation in the 113th Congress.

Notwithstanding our general support for H.R. 2274, NASAA does object to one provision – (a)(13)(G)(iii) State Law Preemption – that references Section 15(i)(1) of the Securities Exchange Act of 1934 (Exchange Act). Section 15(i)(1) governs capital, margin, books and records, bonding and reporting requirements of the Exchange Act, and the limitations on any conflicting or superfluous requirements under state law. NASAA posits that adding Section (a)(13)(G)(iii) in H.R. 2774 creates an unnecessary and confusing addition to an otherwise seamless bill governing M&A brokers. Section 13(G)(iii) titled "State Law Preemption" provides as follows:

> Subsection (i)(1) shall govern the relationship between the requirements applicable to M&A brokers under this Act and the requirements applicable to M&A brokers under the law of a State or a political subdivision of a State. Except as provided in such subsection, this paragraph shall not preempt the law of a State or a political subdivision of a State applicable to M&A brokers.

This "preemption" paragraph in fact refers to a limited preemption already in the Exchange Act addressing books and records, and reporting requirements. NASAA has worked with the M&A industry to obtain their support for withdrawing this language, and we ask that Representative Huizenga and the Committee consider removing this redundant, and arguably confusing, paragraph from the bill.

Business Development Companies

The Subcommittee is presently considering several bills that contemplate relaxation of the portfolio strictures and other limitations on the ability of Business Development Companies (BDCs) to invest in financial companies.

Three bills pending before the Subcommittee – H.R. 31, H.R. 1800, and H.R. 1973 – would repeal the provisions of the Investment Company Act of 1940 (ICA) that limit the ability of a BDC to invest in investment advisers. Two of these bills, H.R. 31 and H.R. 1800, would additionally ease the leverage limits for BDCs established by the ICA, allowing such firms to maintain a greater ratio of debt to asset valuation on their balance sheets, and would direct the SEC to revise its forms and filing instructions for "shelf registrations" to permit BDCs to incorporate by reference in their shelf registrations subsequent financial reports. The most radical change contemplated by any of the bills before the Subcommittee occurs under H.R. 1973, which would redefine financial services companies as "eligible portfolio companies," thereby obviating all existing limitations on the ability of BDCs to invest in financial companies[6].

Before I address these changes, it may be helpful for me to provide the Subcommittee with some background information on BDCs in general. BDCs are regulated, closed-end investment firms that invest in small, developing, or financially troubled companies. As entities that combine the capital of many investors to finance a portfolio of operating businesses, BDCs are governed by the Investment Company Act of 1940 (ICA). BDCs are unique, however, in that they enjoy a number of important exemptions from the ICA that have allowed them in recent years to step into the role that regional commercial banks largely vacated during the financial crisis—lending to companies that may not otherwise get financing.

BDCs are attractive to many investors for three primary reasons. First, investors are drawn to the very high rate return that BDCs offer – sometime in excess of eight percent.[7] Second, under normal market conditions, BDCs also provide investors with liquidity comparable to that of other publicly traded investments. In contrast, investors in open-end investment companies or traditional mutual funds may only sell and buy shares directly to and from the fund itself. The third reason many investors invest in BDCs is

[6] As contemplated by H.R. 1973, financial companies would include not only firms that deal in securities, but also depository institutions like banks and credit unions, insurance companies, credit card companies, and a host of other entities that primarily derive their revenue from financial transactions and the sale of financial products.

[7] Notably, BDCs are also required to distribute at least 90% of their taxable earnings in the form of dividends.

simply access because investors do not need to meet the higher income, net worth or sophistication criteria that are imposed on private equity investments.

By virtue of their unique treatment under the ICA, BDCs enjoy a number of regulatory advantages relative to traditional investment funds. BDCs are permitted to use more leverage than a traditional mutual fund, up to and including a 1-to-1 debt-to-equity ratio. BDCs can also engage in affiliate transactions with portfolio companies. BDC managers also have access to "permanent capital" that is not subject to shareholder redemption or the requirement that capital be distributed to investors as returns on investments are realized. Moreover, managers of BDCs may immediately begin earning management fees after the BDCs have gone public and, unlike other registered funds, charge performance fees.

In exchange for considerable regulatory latitude, BDCs adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs have an asset coverage ratio of 200%, at least 70% of which must be in "eligible" investments.[8] In addition, the ICA prohibits a BDC from acquiring more than 5% of any class of equity securities or investing more than 5% of its assets in any company that derives more than 15% of its revenues from securities-related activities, including acting as a registered investment adviser. It is this part of the regulatory bargain that today's BDC bills attempt to renegotiate.

State securities regulators question the rationale for further relaxing the leverage limits applicable to BDCs, as contemplated by H.R. 31 and H.R. 1800.

As I just mentioned, the current asset coverage ratio applicable to BDCs is 200%. This means that every dollar of a BDC's debt must be "covered" by two dollars of BDC assets. In other words, it effectively limits a BDC's leverage ratio to 50% of assets, which is meant to make BDCs safer and more stable for investors. Excessive leverage by some of our largest financial institutions, as you might recall, was at least part of the problem we faced as part of the most recent financial crisis and many other crises before it. Moreover, the BDC asset coverage ratio has already been adjusted to balance sponsor and investor need, reduced from the initial threshold of 300% for closed-end funds, down to 200%.[9] While BDCs may desire the higher fees they could generate from their increased leverage, that desire is not a compelling justification for increasing leverage and risk to investors, especially unsophisticated retail investors. In the absence of such a justification, NASAA is disinclined to support the measure.

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[8] Eligible investments include: (1) privately issued securities purchased from "eligible portfolio companies," (2) securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director, (3) privately issued securities of companies subject to a bankruptcy proceeding, or otherwise unable to meet their obligations, (4) cash, government securities or high quality debt securities maturing in less than one (5) facilities maintained to conduct the business of the BDC, such as office furniture and equipment, interests in real estate and leasehold improvements.

[9] Under the Investment Company Act of 1940 the asset coverage requirement for closed-end funds is 300% for debt securities and 200% for preferred stock. The Small Business Investment Incentive Act of 1980 reduced the asset coverage ratio for BDCs to 200% from the 300% applicable to non-BDC investment companies under sec. 18(a)(1)(A) of the ICA.

Another change contemplated by H.R. 31 and H.R.1800 that NASAA does not fully understand and, therefore, does not support is the proposal to allow BDCs to issue multiple classes of debt securities and senior equity securities. The effects of this provision on common shareholders, retail investors in every one of your districts, and many senior investors, could be quite harmful. Specifically, allowing BDCs to issue preferred stock is inviting them to dilute the value owned by holders of common stock. Moreover, by allowing preferred stock to count on the equity side of the ratio, the effect of the change would be to permit BDCs to issue greater amounts of debt, potentially placing the holders of common shares in a position where they could be wiped out in the event the BDC incurred losses. This would not serve BDC investors well.

State securities regulators have significant concerns about provisions in H.R. 31, H.R. 1800, and H.R. 1973 that would remove existing prohibitions on the ability of BDCs to invest in investment advisers.

Conflicts of Interest and Business Development Companies

While the foregoing changes are problematic, NASAA's primary concern with the BDC bills is the proposal that would allow BDC investment in IA firms. That proposal would create a significant conflict of interest. If an advisory firm were among a BDC's portfolio of companies, an incentive would exist for the investment adviser to recommend, or even push, their clients toward investments in the BDC or its other portfolio companies, even if such investments were not in the client's best interest.

Such conflicts could be even more troublesome in the context of an adviser's discretionary or "managed" accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. As BDC directors also owe a fiduciary duty to their shareholders, if the proposed change were enacted, it would increase the likelihood that BDCs will acquire interests in advisory firms for the express purpose of accessing the advisory firm's pool of investible capital. This conflict could be exacerbated in the event that a BDC's portfolio company underperforms and the captive advisory firm is seen as a way to shore up the struggling company with additional capital.

No such conflicts of interest exist now, and NASAA urges Congress not to allow for such a conflict of interest to arise as it considers reforms to the BDCs portfolio strictures.

Transparency and Business Development Companies

Beyond the conflict of interest inherent in the repeal of restrictions on BDC investments in advisory firms, NASAA is concerned that such repeal would cause a significant loss of transparency.

BDCs that are registered with the states have limited transparency in a number of respects. State securities regulators usually see them in state registration as startups, or as

businesses with a very limited history of operations. They are frequently "blind pool" offerings in which investors have little or no access to information regarding the investments the BDC will make. Disclosure documents describing eligible portfolio companies can be vague, broad, and limited. For example, a BDC might disclose that it primarily intends to invest in debt and equity securities of small to middle market private U.S. companies. Such vague disclosure as to the use of proceeds grants broad discretion to BDC managers while reducing transparency to investors.

Investors must place their reliance and trust in the management of the BDC to select appropriate companies for the BDC to lend to. Many BDCs have made a niche in lending to companies that have recently struggled with bank financing. Allowing investments in investment advisers adds an additional layer of opacity for BDC investors. NASAA believes BDC investors should continue to receive adequate disclosure about the income producing assets of the investment adviser.

Impact on Shareholders and Job Creation of Business Development Companies

Finally, NASAA cannot help but observe that competition from financial services firms will not benefit traditional BDC portfolio companies – i.e., small businesses.

BDCs were initially created for the purpose of providing capital to domestic small and medium-sized businesses that participate in the real economy. Since their creation, BDCs have enjoyed relaxed regulatory requirements to further this goal; this is the reason financial firms have traditionally been excluded as eligible portfolio companies. Under the proposed legislation, however, these small businesses will presumably face new and greater difficulty obtaining BDC financing because BDC's will reallocate some of their limited resources to investment advisers and other financial firms. Such an outcome may frustrate the Subcommittee's goal of spurring job growth.

Moreover, NASAA is not aware that investment advisory firms have any real need for BDC financing, especially as compared to the smaller real economy firms that BDCs were designed to benefit.

State securities regulators understand and support sensible modernization of regulations applicable to BDCs and other companies.

While most of the proposals set forth in the BDC bills have issues from a state and investor protection perspective, NASAA does support the proposal to extend the relaxed regulatory requirements available to Well Known Seasoned Issuers ("WKSI") and certain other large public filers to BDCs. BDCs operate similarly to large public companies in regard to communications with the public and the filing of forms with the Commission.

Under the amendments contemplated by H.R. 1800 and H.R. 31, BDCs would be eligible for WKSI status and would be eligible to file automatic shelf registrations on forms S-3 or N-2. Automatic shelf registrations are automatically effective upon filing

and receive no SEC review. To be eligible, BDCs would be required to have a class of securities with at least $700 million in public float or have completed a public issuance of at least $1 billion. Some state-registered non-traded BDC offerings have already reached this threshold and would be eligible for automatic shelf registration with limited information and incorporation by reference.

NASAA did not oppose incorporation by reference for real estate investment trust (REIT) offerings a number of years ago, and NASAA similarly does not oppose amending the ICA to permit incorporation by reference for BDCs today.

In summary, NASAA considers that small and mid-size companies that produce goods and services in the real economy have a greater need for BDC loans, and are better positioned than financial companies to use the capital from these loans to create jobs and improve the economy. Repeal of the provisions that limit BDC investment in financial services companies, as contemplated by H.R. 1973, or even investment advisers only, as contemplated by all three of the bills, will, at best, serve to dilute the impact of BDC investment capital as a source of job creation. Such policies might also create incentives for BDCs to help financial services companies design their business strategies, with the main goal of aiding the financial services sector, not building small businesses in other sectors of the economy.

Further Reduction of Publicly Available Information about Emerging Growth Companies

NASAA is also concerned about discussion draft legislation that would further relax reporting requirements for so-called emerging growth companies (EGCs).

Under the proposed discussion draft, EGCs would benefit from a dramatic shortening of the window of time between the completion of a confidential filing with the SEC and the beginning of the "road show" marking its initial public offering (IPO). While NASAA recognizes that from the standpoint of the issuer, the shortening of the required waiting period from 21 days to 5 days may be beneficial, as it reduces the likelihood of external events impacting the offering, the 21 day period is already a relatively short window of time. Moreover, non-EGC companies seeking to go public do not even enjoy an opportunity for confidential review. Like many of the provisions in the discussion draft, this change raises questions about how far Congress is willing to extend favorable treatment to a particular class of companies, and who exactly stands to benefit from such changes.

In addition, whereas the JOBS Act authorized EGCs to submit registration documents to the SEC for review on a confidential basis prior to an IPO, the proposed legislation would permit EGCs to enjoy this same "confidential review" privilege for follow-on offerings of securities issued after the IPO. When Congress established the mechanism for EGCs to obtain confidential SEC review of registration documents under the JOBS Act, its expressed purpose was to encourage companies to go public. It is not

clear why the privilege should now be extended to companies that, by definition, have already successfully completed an IPO.

Similarly, the bill requires that EGCs be permitted to file registration documents for confidential SEC review that "omit financial information for historical periods otherwise required by regulation." Time and again, accounting scandals have shaken public confidence in the markets and demonstrated the critical importance of complete and accurate financial reporting. Such an omission runs counter to the interests of investors, the public, or our capital markets.

The Securities Act of 1933 reflects the principle that "sunlight is the best disinfectant."[10] In fact, during the signing of the bill President Roosevelt emphasized that a well-functioning capitalist system must be built upon a foundation that requires the full disclosure of accurate information to investors:

> Events have made it abundantly clear that the merchandising of securities is really traffic in the economic and social welfare of our people. Such traffic demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts on which the investor's judgment is asked.
>
> To that end this Bill requires the publicity necessary for sound investment. It is, of course, no insurance against errors of judgment. That is the function of no Government. It does give assurance, however, that, within the limit of its powers, the Federal Government will insist upon knowledge of the facts on which alone judgment can be based.[11]

The ink is barely dry on the JOBS Act and we do not yet know what impact Title I will have on the number of IPOs. More importantly, we do not yet know whether it will affect investors' willingness to invest in the emerging growth companies that are so vital to our economy. Despite these uncertainties, the discussion draft would go even further than Title I by reducing the information that is available to investors and giving them less time to digest it.

NASAA respectfully urges the Subcommittee to reject further changes to Title I, at least until the full impact of Title I on investors and securities markets can be observed and evaluated. Until such time, the potential costs and benefits of further expanding Title I will be impossible to determine.

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[10] "[P]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants.... The potent force of publicity must...be utilized in many ways as a continuous remedial measure." Louis D. Brandeis, *Other People's Money* 62 (R. Abrams ed. 1967).
[11] President Franklin D. Roosevelt. "Statement on Signing the Securities Bill," 27 May, 1933, available at http://www.presidency.ucsb.edu/ws/?pid=14654

Tick Sizes and the Small Cap Liquidity Reform Act

Proposals to promote greater liquidity for EGCs or other thinly traded stocks by experimenting with changes to the ''tick sizes,'' or minimum increment for quoting shares, for certain smaller public companies, raise interesting policy questions. However, from a standpoint of public and market-regulatory policy, such proposals also raise a number of concerns.

The proposal that is before the Subcommittee today would direct the SEC to establish a pilot program that would increase the spread between bid and offer prices for EGCs, boosting profits for market-makers. The sponsors of the proposal evidently expect that the increased revenue realized by such market makers from the widened spreads will, in turn, support additional research or "coverage" of the stocks in question. Greater coverage of EGC stocks by analysts, the thinking goes, will in turn lead to more initial public offerings and greater liquidity for EGC shares following their initial offering.

NASAA appreciates that there is less analyst coverage of many smaller company stocks than their shareholders might like; however, we question whether changing the mechanics of the securities market in the hope of subsidizing artificial interest in and coverage of such securities is something Congress should pursue.

There can be little question but that broker-dealers and others who serve as market makers for EGC stocks have a financial incentive to support such a change. It is also understandable that EGCs, and their managers, perceive in such a program the prospect of increased research coverage of their securities, and by extension, greater liquidity.

However, it is far from clear how any of these changes will stand to benefit the investing public. Indeed, quite to the contrary: increasing the spread between bid and ask prices for shares of EGC securities will systemically strip value from the holders of the securities and reallocate it to broker-dealers and others who act as market makers in these securities.

Moreover, as a matter of basic economics, it is evident that by manufacturing additional, artificial transaction costs for the exchange of EGC securities, the proposed pilot program would have the effect of diminishing rather than increasing overall marketplace efficiency.

NASAA believes that, as general matter, Congress should exercise great caution anytime it considers a policy that would make securities or other markets more costly and less efficient.

There are many valid and important reasons why in some instances the government should undertake actions, consistent with the interests of the investing public, which may have the effect of decreasing marketplace efficiency – for example, to protect investors from fraud and abuse, to prevent excessive speculation, or to prevent market panic. In this instance, however, the proposed pilot program appears to offer little, if any, of these benefits to the investing public while increasing their transaction costs.

eXtensible Business Reporting Language (XBRL)

eXtensible Business Reporting Language (XBRL) is an international standard used for exchanging and reporting business information. XBRL makes use of "interactive data" to indentify trends and patterns that would not otherwise be recognizable or accessible.

XBRL allows for the automated processing of business information by computer software, cutting out laborious and costly processes of manual re-entry and comparison. This is highly useful for financial regulators such as the SEC, since the SEC's computers can recognize information filed in XBRL format, analyze it, store it, and ultimately compare it on an "apples to apples" basis with other filings to obtain an extremely precise and highly useful picture of market participants and market activities.[12] Interactive data also allows investors and others to pinpoint facts and figures within often lengthy disclosure documents.[13]

In early 2009, the SEC published three final rules requiring XBRL tagging of certain disclosure information for operating companies, mutual funds, and credit rating agencies. One of the bills before the Subcommittee today would effectively repeal this requirement for firms with total annual revenues of less than $1 billion. Under the bill, roughly three in every four public companies would be exempt from providing this meaningful information.

As a general matter, NASAA shares the view of other advocates for transparency, from the SEC's Investor Advisory Committee to the Chairman of the House Committee on Oversight and Government Reform, in supporting the use of XBRL and other filing protocols that maximize meaningful disclosure that benefits the investing public.[14] Accordingly, NASAA does not believe that Congress should, at this time, repeal the XBRL reporting requirement for all public companies with less than $1 billion in annual revenues.

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[12] Federal Financial Institutions Examination Council. Report entitled: "Improved Business Process Through XBRL: A Use Case for Business Reporting" 31 January, 2006. Accessible at http://www.xbrl.org/Business/Regulators/FFIEC-White-Paper-31Jan06.pdf.

[13] Securities Exchange Commission. http://www.sec.gov/spotlight/xbrl/what-is-idata.shtml.

[14] Letter from House Oversight and Government Reform Committee Chairman Darrell E. Issa to SEC Chair Mary Jo White regarding SEC implementation and enforcement of the Interactive Data to Improve Financial Reporting Rule of 2009. 10 September, 2013. Accessible at http://oversight.house.gov/wp-content/uploads/2013/09/2013-09-10-DEI-to-White-re-Interactive-Data-Rule.pdf.

At the same time, state securities regulators are very sensitive to the compliance cost that XBRL may be placing on some truly small companies, and in the case of such companies, we would hope that Congress and the SEC would afford filers with a more limited exemption, or forbearance, to minimize any excessive cost or burden associated with this new filing protocol.

Other Ideas for Spurring Capital Formation Through Pro-Investor Reforms

NASAA shares the goal of Congress to improve the United States economy by spurring private investment in businesses. However, we are concerned that the Committee may be attempting to reach this goal through a strictly one-sided approach – namely, by eliminating regulations that appear to be burdensome to businesses who want to raise capital. We encourage the Committee to take a more balanced approach and to consider reforms that will restore investor confidence in the markets. What we need is smarter regulation, not merely deregulation.

A Gallup survey in June 2002 found that 67 percent of Americans owned a 401(k) or otherwise invested in individual stocks, bonds, or mutual funds. Earlier this year, that number was down to 54 percent.[15] If this Subcommittee wants to spur economic development through capital formation, it should focus on giving that missing 13 percent the confidence to re-enter the marketplace.

The reasons for investor nervousness seem obvious. Many Americans lost a big share of their retirement savings during the economic meltdown and now view the stock market as a "casino" that is rigged by insiders and high frequency traders. These investors also hear about computer errors and false news stories that cause flash crashes, and they understandably wonder whether the markets are sufficiently stable to invest their retirement savings.[16]

Of course, this is not the first time in our history that investors need their faith in the markets restored. The original Securities Act of 1933 was not meant to punish Wall Street for the stock market crash of 1929, but rather to lift the country out of the resulting depression by restoring investor confidence and spurring new capital formation. Felix Frankfurter, a principal drafter of the Securities Act, spoke of the strain on our markets at that time:

> The great and buoyant faith in capitalism, in the competitive system, is largely deflated, and . . . it is not only a question of whether the system is just, but whether it works. When you have a system which is questioned

[15] See http://www.gallup.com/poll/147206/stock-market-investments-lowest-1999.aspx.

[16] In the past several years, major market disruptions that have not been adequately explained, but which appear to be linked to electronic trading, include the May 6, 2010 "Flash Crash," the BATS IPO, and the Knight Capital "fat finger" incident.

by the masses, that system cannot last unless it wins back the loyalty and allegiance of the doubters. . . .[17]

Today, investors need a similar boost of confidence in the securities markets. It is counterproductive to capital formation when Congress continually chips away at the protections that investors have come to expect, and Congress could help small businesses more effectively by looking for reforms that will make investors comfortable investing again. NASAA has not yet come to firm conclusions about reforms that would provide a cure to investor cynicism, but we are intrigued by a few ideas that seem worthy of further study by this Committee.

First, we believe that Congress should study the impact of high frequency trading and take steps to ameliorate any harm to retail investors. According to Charles Schwab, high frequency traders flood the market with orders to evaluate the market, then cancel 90 percent or more of the orders and retain only the advantageous trades.[18] To curb these abuses, some European governments have proposed transaction taxes on all orders that are placed in the markets, but Mr. Schwab has suggested a narrower approach that would probably be less controversial and more effective – a penalty on excessive cancellations.[19]

Another innovative effort to combat high frequency trading has been undertaken by ParFX and EBS, two international currency trading platforms. They use a randomized pause so that the first order placed in the system queue is not necessarily the first to be executed.[20] According to Larry Tabb, founder of the TABB Group, "In the equities market, it's going to be pretty tough for an exchange to introduce randomization because the regulations have been interpreted to be very time-price specific."[21] Therefore, Congress might consider amending the laws to allow this type of reform in the United States equities marketplace.

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[17] L. Baker, Felix Frankfurter 146 (1969) (taken from a Frankfurter speech delivered at Smith College, Feb. 22, 1933). The Securities Act of 1933 was successful in encouraging investors to reenter the capital markets. The issuance of new corporate securities had grown from $6.5 billion in 1927 to $9.4 billion in 1929, but it fell off dramatically after the stock market crash to $644 million in 1932 and $380 million in 1933. Bureau of the Census, Historical Statistics of the United States: Colonial Times to 1970 1006 (1975). However, after adoption of the Securities Act of 1933, new corporate securities issues quickly increased to over $2.5 billion in 1935 and over $4.3 billion in 1936. Goldschmidt, Registration under the Securities Act of 1933, 4 Law & Contemp. Probs. 19, 28 (1937).

[18] Charles Schwab and Walt Bettinger, Why Individual Investors Are Fleeing Stocks, Wall Street Journal Editorial, July 10, 2013, available at http://online.wsj.com/news/articles/SB10001424127887323582904578484810838726222?mod=dist_smartbrief.

[19] Id.

[20] Eric Onstad, Analysis: 'Slow Frequency' Technology Faces Tough Shift from FX to Stock Markets, Reuters, October 2, 2013, available at http://www.reuters.com/article/2013/10/02/us-hft-curbs-analysis-idUSBRE9910PJ20131002.

[21] Id.

Congress could also study the numerous electronic "glitches" that have plagued the markets with market shutdowns and price instability. Many have called for mandatory "kill switches" to stop trading when problems occur, but we believe more aggressive steps should be taken to ensure that our markets are protected. If such havoc can be wrought from innocent errors by companies who have every incentive to get things right, then we worry what could be done by someone with a malicious intent to harm the markets or the country.

Improving Investment Adviser Oversight and Preserving Investor Choice

Finally, state securities regulators continue to support legislation introduced in the House by Ranking Member Maxine Waters that would authorize the SEC to collect "user fees" from federally registered investment advisers, and to use the revenue derived from these fees to fund more frequent examinations of such advisers. We would also like to congratulate Congressman Keith Ellison for introducing the Investor Choice Act of 2013, H.R. 2998. This bill preserves an investor's right to access the court system if the investor has a dispute against a broker or investment adviser. H.R. 2998 is a direct response to the longstanding practice in the broker-dealer industry, and most recently among investment adviser firms (despite advisers' fiduciary duty), of including mandatory pre-dispute arbitration agreements in client contracts. Retail investors deserve a choice, not a mandate, when it comes to disputes affecting their financial portfolios.

Taken together, these two bills constitute major steps that Congress could take today to restore investor confidence in the fairness and soundness of our securities markets, and those who they trust to invest their retirement and savings in these markets.

Thank you again, Chairman Garrett and Ranking Member Maloney, for the opportunity to appear before the Subcommittee today. I would be pleased to answer any questions that you may have.

TESTIMONY OF

MICHAEL J. AROUGHETI
CHIEF EXECUTIVE OFFICER
ARES CAPITAL CORPORATION

BEFORE THE

HOUSE SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

"LEGISLATION TO FURTHER REDUCE IMPEDIMENTS TO CAPITAL FORMATION"

OCTOBER 23, 2013

I. Introduction

Chairman Garrett, Ranking Member Maloney and members of the Sub-Committee, thank you for the opportunity to testify today. My name is Michael Arougheti and I am the Chief Executive Officer of Ares Capital Corporation, an SEC registered Business Development Company, or "BDC", and one of the largest non-bank providers of capital to small- and medium-sized American companies – the backbone of the U.S. economy. Ares Capital Corporation is publicly-traded on the NASDAQ National Market and is currently the largest BDC by both market capitalization and assets. Since our IPO in 2004 through June 30, 2013, we have invested more than $14 billion in more than 450 small and medium sized American companies, in the process creating tens of thousands of new jobs and providing capital to growing businesses who were unable to access capital through commercial banks or other traditional financing sources.

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". Specifically, after a period of rapid growth, a downturn caused banks to retrench from lending and left small and medium sized businesses with limited options for securing credit. The stated objective of BDCs was to encourage the establishment of new market vehicles to invest in, and increase the flow of capital to, private businesses. By mandate, BDC's are also required to provide managerial assistance to their portfolio companies. Uniquely, the BDC model allows ordinary investors exposure to start-up and small companies – effectively "Main Street funding Main Street".

Today, the middle market employs two out of every three workers in the private sector.[1] Based on data from ADP, small- and medium-sized businesses have lost a combined 843,000 jobs since the beginning of 2008.[2] In contrast, many companies funded by the BDC industry during that same period have been able to increase hiring and grow their respective businesses.

The impact of BDC's on small- and medium-sized businesses has been tangible and meaningful. By way of example, in 2004 Ares Capital Corporation made an initial investment in Reflexite, an employee-owned producer of optical components and films for the Safety, Lighting, Instrumentation and Display markets based in Avon, CT. Reflexite needed to raise capital to, among other things, expand product lines and seed new businesses. However, Reflexite was at a stage in its life cycle where neither a traditional senior debt provider nor a private equity firm was the right fit to provide what Reflexite was looking for. Traditional senior debt providers were not a good fit as their proposed capital was inflexible, they had low tolerance for risk as Reflexite grew new businesses and they could not provide a sufficient amount of capital. Similarly, private equity sources were not a good match as they wanted to be able force liquidity within a certain time frame, which was incompatible with a private company that wished to preserve autonomy and invest in growth over the long term. Because BDCs such as ARCC are "permanent capital" vehicles, they often have a longer investment horizon and can provide more flexible capital to companies like Reflexite. Ares Capital Corporation not only provided capital, but also took seats on Reflexite's board of directors and provided valuable strategic advice and support to the company as it grew.

[1] Source: ADP National Employment Report – September 2013. Nonfarm private sector employment for companies with 1 to 49 employees and companies with 50 to 499 employees.

[2] Source: ADP National Employment Report – September 2013. Sum of small- and medium- sized businesses. Small businesses defined as less than 50 employees. Medium businesses defined as 50 to 499 employees.

Today there are over 40 publicly-traded BDCs with an aggregate market capitalization of more than $25 billion and approximately $40 billion in assets. While all BDC's do not look alike with respect to criteria such as size of investments, size of portfolio companies and industry focus, all BDCs do share a common investment objective of improving capital access. As traditional lending institutions have been inconsistent in providing loans to small and medium size companies, BDCs now find themselves in a very similar position as they were in 30 years ago – at the forefront of the effort to address the unmet capital needs of small business.

While the BDC industry continues to grow, I strongly believe that we can expand our scope and do more to fulfill our policy mandate. To that end, I am here today on behalf of the BDC industry to express support for current proposed legislation that seeks to make straightforward, prudent changes to the Investment Company Act of 1940 in order to enable BDCs to more easily raise and deploy capital to small and medium size businesses. **It is important to note that BDCs are not seeking any government or taxpayer support or subsidy**. The BDC industry is simply asking Congress to modernize their regulatory framework so that BDCs can more easily fulfill their Congressional mandate.

II. Policy Challenges / Proposed Policy Solutions

BDCs are heavily regulated and appropriately, the activities of BDCs are fully transparent to regulators, investors and portfolio companies. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. BDC's fall under the supervision of the SEC's Division of Investment Management.

Ironically, many of the challenges faced by BDCs in increasing both the scope of borrowers and the amounts that BDCs can invest arise out of their place in this regulatory framework. Given that BDCs are more akin to operating companies such as banks and other commercial lenders than to mutual funds, BDCs must often play the part of the proverbial "square peg being in a round hole".

So, the question then becomes how to enable BDCs to fulfill their Congressional mandate of being an active provider of capital to small and medium sized companies, while remaining appropriately regulated?

The answer – begin the process of modernizing the regulatory framework with a handful of modest, common sense changes. Clearly, the world is a much different place than it was in 1980 when Congress created BDCs.

During the "Great Recession", we all learned a number of lessons which hopefully will be taken to heart as the economy continues to improve. One of the important lessons learned by BDCs was that during a downturn, structural constraints in the existing regulatory framework are punitive not only to BDCs but also to the many small and medium sized companies they serve. Three bills have been introduced in the House to modernize the regulatory framework for BDCs

and to mitigate/eliminate many of the issues faced in 2008, thereby ensuring that BDCs can continue to fulfill their Congressional mandate today and in the future.

The first two, H.R. 31 (Velasquez) and H.R. 1800 (Grimm), relate directly to the issue of capital formation and, ultimately, capital flows to small and medium sized businesses through modest, common sense amendments to the Securities Act of 1933 and the Investment Company Act of 1940. In short, they seek to enable BDC's to "do more" than they are currently able to in terms of the number of companies that they can lend to, the types of investments they can make and the amount of capital that they can raise and deploy.

These two bills contain four nearly identical provisions, which we believe illustrates the significant bipartisan support for these changes.

- **First**, both bills propose an increase in the BDC asset coverage test from 200% to 150%, thereby broadening the universe of potential borrowers that can access loans from a BDC. We do not believe that the proposed change introduces more risk. Rather, it should allow BDC's to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test actually forces BDC's to invest in riskier, higher-yielding securities in order to meet the dividend requirements of their shareholders. This potential "de-risking" is further supported by the strong underlying performance of the loan asset class. For example, during the period from our IPO through June 30, 2013, ARCC's non-accrual rate on first lien senior secured loans was 0.8% while the average default rate of the S&P LSTA Leveraged Loan Index for first lien senior secured loans for that same period was 2.49%.[3] Similarly, since inception BDCs have generated a cumulative gain / loss rate of negative 62 bps, outperforming banks by 186 bps.[4] We believe that this proposed change will benefit borrowers through greater financing alternatives and a reduced cost of capital and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios.

  In addition, this proposed change would apply to BDCs the same leverage ratio as the leverage ratio for Small Business Investment Companies but, unlike SBICs, without putting any government capital at risk. This seems prudent, consistent with other legislation that this sub-committee has passed and, as I noted, benefits both small and medium-sized companies and shareholders without any government or taxpayer subsidy.

  An increase in this ratio will also provide additional "cushion" given the requirement that BDC's must "mark to market" their loans each quarter. Specifically, in the event of falling asset values in the overall market as we saw during the Great Recession, unlike banks and other commercial finance companies BDCs are generally required to write down the value of certain of their otherwise performing assets. Currently, most BDCs have an average leverage ratio of 0.5x-0.75x, reflecting a desire and a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep

[3] Source: S&P LCD data for LSTA Leveraged Loan Index ("LLI"). Calculated as the average of LTM rolling monthly default rates over the period from October 2004 through June 2013.
[4] Source: TPG Specialty Lending: 2013 Wells Fargo BDC Leadership Forum – Rating Agency Concerns about BDCs

drop in asset values. However, the maintenance of such a cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress. This additional cushion would provide BDCs with the ability to deploy more capital in the ordinary course and through market cycles.

This proposed change is extremely modest given that banks customarily incur leverage of 10:1 and greater. Further, contrary to those commentators who would suggest otherwise, a decrease in the asset coverage test will not result in an automatic, immediate increase in risk. BDCs will still need to act prudently for the reasons noted above and the "market", including lenders and debt investors, will ultimately make the determination as to "how much leverage is too much".

Finally, given the transparency required of BDCs in their SEC disclosure documents, shareholders will be clearly informed (as they are now) of the amount of leverage that BDCs can incur and any potential risks to them associated with such leverage. This applies equally to retail investors as well as institutional investors, who comprise approximately 40% of BDC shareholders.[5]

- **Second**, both bills would allow BDCs to treat preferred stock as equity rather than as debt and eliminate the requirement that holders of preferred stock have board representation. Many BDCs were challenged during the last downturn, in particular with respect to issuing common equity at a price below net asset value. Had BDCs been able to raise capital during the post 2008 period by issuing preferred shares as equity, many more loans could have been made to cash-starved companies to enable them to retain employees and, in some instances, to remain in business.

- **Third**, apart from a handful of minor differences, both bills direct the SEC to make specific technical amendments to certain securities offering rules applicable to BDCs. Currently, despite the need for regular access to the capital markets, BDCs are the only seasoned issuers required to comply with certain provisions of the 1933 Act which, in turn, makes raising capital cumbersome and inefficient. These rule changes would merely place BDCs on equal footing with non-BDC's without any accompanying decrease in transparency or shareholder protection.

- **Fourth**, both bills would allow BDCs to own registered investment advisers, which as a technical matter is currently prohibited under the 1940 Act. Apart from viewing these as attractive investment opportunities, investments in RIAs enable money to be raised from third party investors which, in turn, can be deployed to small and medium-sized companies. Under prior rules, an investment adviser did not have to register if it had less than 15 clients and, accordingly, it could be owned by a BDC. The recent removal of this exemption, without any corresponding rulemaking to address the technical glitch caused by such removal, has left BDCs in the uncomfortable position of (1) simply not investing in RIAs at all or (2) for BDCs with existing RIA subsidiaries or portfolio companies, engaging in a fire sale if the SEC doesn't grant permission for such BDCs to continue

[5] Source: Wells Fargo BDC Leadership Forum materials.

ownership of an RIA post-registration. Currently the SEC has been granting exemptive relief from this rule on a case by case basis; this amendment will eliminate this often lengthy and expensive process.

The modest asset coverage ratio increase and change in treatment of preferred stock contained in both H.R. 31 and H.R. 1800, would become effective immediately upon passage. The other provisions will require action by the SEC. Accordingly, we would urge the Sub-Committee to work with the SEC to make these proposed changes in a timely manner.

Last but not least, H.R. 1973 introduced by Congressman Mulvaney, offers welcome flexibility for BDC investment in financial institutions currently limited by the 30% basket. For example, a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context feels quite arbitrary.

III. Closing Remarks

In conclusion, we believe that the time is right to modernize the BDC sector and pass legislation which would allow BDC's to increase capital flows to America's small and medium size companies, spur economic growth and create. We are encouraged by the bi-partisan focus on this important initiative, and look forward to working with the Committee in moving these bills forward.

On behalf of the entire BDC sector, I'd like thank Representatives Grimm, Velazquez and Mulvaney for their efforts and urge the sub-Committee to act favorably on a BDC modernization bill. Again, I appreciate the opportunity to testify today and would be pleased to answer any questions.

United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing Entitled:
"Legislation to Further Reduce Impediments to Capital Formation"
Room 2128 Rayburn House Office Building

October 23, 2013

Written Statement by
J. Michael Ertel, Managing Director
Legacy M&A Advisors, LLC

Submitted for and on behalf of the

Alliance of Merger & Acquisition Advisors
200 East Randolph Street, 24th Floor
Chicago, Illinois 60601

With respect to H.R. 2274
The Small Business Mergers, Acquisitions,
Sales, and Brokerage Simplification Act of 2013

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Introduction

Chairman Garrett, Ranking Member Maloney, members of the Capital Markets Subcommittee, thank you for this opportunity to explain how today's "one-size-fits-all" system of regulating securities broker-dealers adversely impacts owners of privately held companies who seek professional advice and business brokerage services to sell, buy, or grow their small- and mid-sized businesses through privately negotiated mergers, acquisitions, sales, and other business combination transactions ("M&A transactions").

Public Policy Considerations

Public policy considerations supporting H.R. 2274, the *Small Business Mergers, Acquisitions, and Sales Brokerage Simplification Act of 2013*, date back to the 2005 American Bar Association, *Report and Recommendations of the Private Placement Broker-Dealer Task Force*,[1] and the 2006 *Final Report of the Advisory Committee [to the SEC] on Smaller Public Companies*,[2] as documented in the oral and written testimony submitted by Shane Hansen, a securities law partner with Warner Norcross & Judd LLP, who testified about H.R. 2274 at a hearing before this Subcommittee on June 12, 2013.[3]

[1] Available on the SEC's website at www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.
[2] Available on the SEC's website at www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.
[3] "*Reducing Barriers to Capital Formation*," available on the Subcommittee's website at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=336906.

Representing Legacy Advisors & AM&AA

My testimony is based on my personal experience as Co-Chair of the *Campaign for Clarity*, a profession-wide effort to bring clarity to the regulation of M&A advisors, intermediaries, and business brokers ("M&A brokers"), led by the Alliance of Mergers & Acquisitions Advisors (AM&AA), and supported more than 16 other international, national and regional professional associations of M&A brokers and related professionals.[4] It is also based on my personal experience in providing business brokerage and M&A advisory services to sellers and buyers of privately held businesses since 2000, and being a small business owner myself.

Since July 2011, I have been registered as a representative of an SEC- and state-registered broker-dealer and member of the Financial Industry Regulatory Authority ("FINRA"), but I am not speaking for or representing that brokerage firm in my remarks today. I became registered with a fully-registered broker-dealer in order to comply with today's "one-size fits all" regulatory scheme because, in seven years of persistent efforts by the AM&AA and the supporting professional associations, the Securities and Exchange Commission ("SEC") has not addressed this critical small business issue through rulemaking.

The Business Context

For most business owners, the sale of their business is one of the largest personal financial transactions of their lives, but something many will likely do only once. It represents their best opportunity to reap the financial rewards of their work, time – for some a lifetime – and money. While business owners may be experts at managing and growing their own businesses, they generally have little or no experience in preparing their business for sale; identifying and screening prospective buyers; assembling, packaging, and presenting information relevant to prospective buyers; valuing their business, its assets, and its income streams; assessing the pros, cons, and quality of purchase offers; structuring the transaction; managing the pre-purchase due diligence process; guiding the transaction through unexpected operational and human resource obstacles; preparing for the transition of ownership and management; and

[4] See the list in Exhibit 1 to this written statement.

completing the transaction. While their attorneys and accountants provide valuable legal, tax, and accounting advice, astute business owners recognize they may need an experienced professional intermediary to quarterback the entire business sale process from start to finish, since they will not get a second chance to get a successful outcome.

For example, most private business owners plan and file their corporate tax returns to legitimately minimize their taxes, such as by accelerating deductions and deferring income recognition. Often, tax-driven business planning fails to reveal the true market value of their business. Consequently, financial statements and related records must be carefully analyzed and presented to better reflect the value of the business to prospective buyers and to fully support the business sale process. Many private business owners need and turn to the professional services of an M&A broker to facilitate these processes.

M&A transactions involving privately owned businesses may have a variety of different legal structures depending on many factors, principally driven by the business objectives of the parties. Regardless of the M&A transaction's legal structure, the parties' common objective is to convey or combine ownership and control of an existing business so that the enterprise can continue to operate and grow, to preserve existing jobs, and to create new jobs. There are many reasons for sellers to seek an M&A transaction. M&A transactions occur when, for example, one or more private business owners want to exit the business or retire by selling his or her stake in the company. Sometimes owner want to sell part or all of the business to its employees. Sometimes the business needs more or different skill sets to take it to the next level. Sometimes a larger company wants to divest the business conducted by a division or a subsidiary.

The legal structure and the process required to complete an M&A transaction is affected by many factors including, for example, the size of the business, the nature of its operations and assets, the business risks, the industry type, the industry participants, the historical financial performance, the operating capital requirements, the business development stage (e.g., start-up or mature), the human resources, the intellectual property, the market for its products or services, and the applicable regulatory requirements. Some prospective buyers may prefer to acquire the

business' assets for a variety of reasons, including considerations such as taxes and business risk mitigation. Sellers commonly prefer to receive all cash at closing. Cash-for-assets transactions are usually outside the jurisdiction of federal and state securities laws, though under some circumstances contract terms such as an "earn-out" or a buyer's promissory note issued to the seller may subject the transaction, the parties, and the M&A broker to securities law and regulation. In many instances it may be undesirable or impractical to structure an M&A transaction as cash-for-assets because there are income tax advantages for the sellers to prefer cash-for-stock or stock-for-stock exchanges, which are within the jurisdiction of federal and state securities laws. The final legal structure of an M&A transaction may not be known until late in the sale process, which can span many months or even years. While all of these transaction structures result in the sale of the business, some of these legal structures are subject to federal and state securities laws, including broker-dealer regulation of the M&A broker, while other legal structures are not subject to securities regulation at all.

Selling a privately owned business requires knowledge of multiple disciplines affecting all aspects of that business. Smaller businesses may or may not have in-house expertise, and may or may not be able to afford consultants or specialists, in the relevant disciplines. Accordingly, an M&A broker serving smaller businesses often needs to be a competent generalist and "jack of all trades", knowing when and where special expertise is needed. M&A brokers educate the seller on the selling process; help prepare the business for sale; analyze company's financials and its business; perform or coordinate valuation; advise on potential capital sources and capital structure; understand the business operations; prepare business offering information packages; identify, market, and screen qualified potential buyers; assist in organizing and facilitating the buyer's due diligence; and coordinate communications with the parties' lawyers, accountants, and other consultants. An M&A broker's knowledge and experience with these and other business factors are critically important to the success of an M&A transaction.

Regardless of legal structure, in M&A transactions the prospective buyers conduct their own extensive due diligence investigation into the seller's business, financial performance, management, operations, assets, liabilities, and business risks. The prospective buyers will control and run the businesses after the transaction's closing. Commonly, the prospective buyers have substantial business experience, employ their own knowledgeable operational and financial officers and managers, and are advised by their own lawyers, accountants, commercial bankers, and consultants. Sometimes the prospective buyers are larger, more sophisticated companies or private equity groups. The buyer's due diligence team has complete access to the seller's business, which the buyer will ultimately own, control, and run. The parties negotiate their contractual representations, warranties, covenants, rights, and remedies, and may enforce their rights in court, rather than merely relying upon the antifraud protections and remedies in federal and state securities laws that are important to passive, non-controlling investors. Commonly, the parties' lawyers close the M&A transactions and control the exchange of the purchase consideration. In effecting the sale of a privately owned business, M&A brokers are not in the business of selling securities to passive investors; they are not raising capital; they are not holding either party's funds or securities; they are not investing funds for account of others.

Not all M&A transactions that start are successfully closed. Commonly, M&A brokers are primarily paid for their services with a contingent success fee so, apart from reimbursement of expenses, the seller does not incur the cost of these services unless the transaction is completed. While this compensation structure helps to align the interests of the seller and the M&A broker, it also means that the M&A broker may commit a substantial amount of time – often many months and sometimes several years – to working on behalf of the seller without current pay checks. M&A transactions fall apart frequently for a variety of reasons unrelated to the M&A broker or its services. For example, a prospective buyer may be unable to get financing, the buyer's discovery in due diligence of unacceptable business risks such as off-balance sheet liabilities, or the parties' inability to negotiate a satisfactory purchase price or contractual representations, warranties, indemnifications, and other remedies. An M&A broker

may have to find and screen multiple prospective buyers to ultimately sell a business, or may have to walk away from a sell-side engagement without compensation if no M&A transaction is closed. Most M&A brokers are themselves small businesses. High fixed overhead costs, including the cost of maintaining today's complex broker-dealer compliance infrastructure, are difficult to sustain when an M&A broker's compensation for services rendered is neither periodic nor predictable.

Today's Compliance

The current one-size-fits-all regulatory scheme requires M&A brokers to comply with the same SEC and FINRA regulations that govern Wall Street investment bankers and retail securities brokers. This requires registration with and extensive regulation by the SEC and FINRA, as well as compliance with various state securities laws, real estate brokerage laws, and business brokerage laws. The vast preponderance of existing federal regulation has been designed and enhanced to better protect our public markets and passive investors, and so imposes burdensome and complex requirements that are largely irrelevant in the context of private M&A transactions.

The 2006, 2007, 2008, 2009, 2010, and 2011 Final Reports and Recommendations of the Government-Business Forum on Small Business Capital Formation hosted by the SEC have recommended that the SEC take the lead in clarifying and simplifying the complex, overlapping, and unduly burdensome securities regulations that presently regulate M&A brokers.[5] In 2011, former SEC Chairman Schapiro acknowledged to Members of Congress[6] the need for the agency to review the application of existing rules to M&A brokers in the privately negotiated sale of a business context, but no rulemaking has been undertaken and, since the enactment of the Dodd-Frank Act, there have been other Congressionally-mandated priorities.

[5] These reports are available on the SEC's website at http://www.sec.gov/info/smallbus/sbforum.shtml.
[6] Ms. Schapiro's letter is among the exhibits to Mr. Hansen's written statement available on the Subcommittee's website at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=336906.

Cost of Compliance

Almost all M&A brokers operate as very small firms. For a typical small M&A broker to organize itself as a registered broker-dealer, the initial cost to organize and operate for the first twelve months of operations has been estimated to exceed $250,000.[7] Annual fixed compliance costs are estimated to exceed $75,000 regardless of the number of M&A transactions handled or closed during the year. Because M&A brokers are commonly compensated by a contingent success fee, they must carry the entire cost of operations, including compliance, until each M&A transaction's closing.

Since most M&A brokers close a very small number of transactions per year—sometimes none—and since not all of those transactions are even subject to securities regulation, the initial and on-going compliance cost required to handle a very small number of securities transactions is disproportionately burdensome to these small firms. Ultimately, these costs must be passed on to the business owners in order for the M&A broker to remain in business.

Need to Act Now

Various authors[8] have observed that as the baby boomer generation reaches retirement, millions of small businesses affecting millions of employees will be transitioning to the next generation of owners. To better protect these senior business owners who frequently have up to 90% of their net worth tied up in their businesses through direct investment and personal guarantees, many will need the assistance of an M&A broker. The perception of public protection through today's "one-size fits all" broker-dealer regulation is illusory, because there are thousands of small, unregistered M&A brokers across the country, who are either unaware that their activities require broker-dealer registration and regulation, or have chosen to ignore this requirement due to the extraordinarily high cost and lack of relevance to the professional services they provide. The parties rely upon their negotiated contractual representations, warranties,

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[7] See Exhibit 2, Estimate of Pro Forma Broker-Dealer Compliance-related Costs, and Exhibit 3, FINRA Gross Income Assessments and Various Registration Fees, for some of these compliance-related costs.

[8] Richard Jackim, Peter Christman, *The $10 Trillion Opportunity*, Exit Planning Institute (2006); Robert Avery, Cornell University.

covenants, rights, and remedies drafted by their own attorneys for their own protection, rather than on the general antifraud prohibitions and protections designed for passive investors.

The Impact of H.R. 2274 on Economic Growth

Capital formation, economic growth, and jobs preservation and creation by small and mid-sized businesses are all facilitated with cost-effective M&A advisory and business brokerage services.[9] H.R. 2274 would direct the SEC to create a simplified system of M&A broker registration through a public notice filing. The bill would direct the SEC to review and tailor rules relevant to the context in which M&A brokers provide professional services. The bill would direct the SEC to work with state securities regulators to develop appropriate client disclosures about the firm and its professional staff, services, fees, and conflicts of interest (conceptually similar to those required from investment advisers), and professional qualifications. No new federal preemption of state laws would be created by H.R. 2274. State securities laws would continue to apply to M&A brokers. State securities regulators would continue their role in providing important protections for business sellers buyers. Appropriately scaling federal securities regulation of M&A brokers in view of the foregoing considerations would ultimately free-up the SEC's and FINRA's resources to better protect our public markets and passive investors.

Exhibits

This written statement is accompanied by a number of exhibits with supporting information, which are incorporated here by reference.

Conclusion

I urge you to support H.R. 2274 and look forward to your questions.

[9] See Exhibit 4, *A Bipartisan Small Business Fix*, Michael Nall, AM&AA Founder, October 8, 2013 posted to the Hill.com.

Exhibits Accompanying

Written Statement by
J. Michael Ertel, Managing Director
Legacy M&A Advisors, LLC

October 23, 2013

Exhibit 1	List of Professional Association Supporters
Exhibit 2	Estimate of Pro Forma Broker-Dealer Compliance-related Costs
Exhibit 3	FINRA Gross Income Assessments and Various Registration Fees
Exhibit 4	*A Bipartisan Small Business Fix*, Michael Nall, AM&AA Founder, October 8, 2013, posted to the Hill.com.
Exhibit 5	J. Michael Ertel Biography
Exhibit 6	"Truth in Testimony" Disclosure Form

Exhibit 1

Supporting Professional Associations

AM&AA Campaign for Clarity
Supporting Professional Associations

As of October, 2013

- Alliance of Merger & Acquisition Advisors (AM&AA)
- MidMarket Alliance (formerly Alliance for Corporate Wealth (ACW))
- Midwest Business Brokers & Intermediaries (MBBI)
- International Business Brokers Association (IBBA)
- M&A Source (MAS)
- Business Brokers of Florida (BBF)
- Colorado Association of Business Intermediaries (CABI)
- Mid Atlantic Business Intermediaries Association (MABIA)
- Texas Association of Business Brokers (TABB)
- California Association of Business Brokers (CABB)
- Institute of Certified Business Counselors (ICBC)
- Arizona Business Brokers Association (AZBBA)
- Georgia Association of Business Brokers (GABB)
- Michigan Business Brokers Association (MSSA)
- Carolina Virginia Business Brokers Association (CVBBA)
- Nevada Business Brokers Association (NBBA)
- Alliance for Corporate Growth (ACG)

The Campaign for Clarity is also supported by numerous individuals and firms.

Exhibit 2

Estimate of Pro Forma Broker-Dealer Compliance-related Costs

Estimate of Pro Forma Broker-Dealer Compliance-related Costs

Subject BD: ABC Capital Markets, LLC

All amounts are estimates				
Capitalization				
Required Minimum Net Capital			$ 5,000	Broker-Dealer's basic required Net Capital for an Investment Banking firm is typically $5,000, but depends on how the firm is set-up. It could be as much as $50,000. (business lines to push a firm to the $100,000 requirement - Proprietary Trading, Firm Commitment Underwritings, Market Making)
Required excess net capital "cushion" (20%)			$ 1,000	
Additional required capital for 12 months			$ 161,768	FINRA requires enough capital to cover 12 months of anticipated expenses with no revenues (you may get by with 6 months if you show you can put more capital in quickl
Total Initial Capitalization			$ 167,768	
Annual Regulatory and FINRA Related Operating Expenses Fees				
Firm				
FINRA Charges to Pursue an New Member Application (NMA)			$ 7,500	The New FINRA NMA fees start at $7,500 and range up to $55,000 depending on the size and permissions of the firm.
FINRA Registration Fees - Firm			$ 3,000	
FINRA Assessment Fees - Firm			$ 5,000	Calculated at the end of the Calendar year. Formula based on number of representatives, branch offices and gross revenues from securities transactions.
SIPC			$ 2,500	Based on percentage of gross revenues - .25% of net operating revenue.
Audited Financials (Per SEC and SOX)			$ 12,000	
E&O Insurance			$ 15,000	M&A Only can be as low as $10k/year for a $1MM policy, for Private Placements up to $60k/year if you're provided a quote at all
Rule 3010 Requirements (Email and Data Storage Services)			$ 2,500	This number can range in multiples higher when the firm is larger
Fidelity Bond Premium			$ 1,500	Based on number representatives, branch offices and net capital requirement
Financial and Operations Principal's Services (est. $1,000/mo)			$ 12,000	If no FINOP in-house and services are outsourced monthly
Number of State Registrations\ Individuals (Average $50/pp)		10	$ 5,000	
State Registration (Per State Average) @	$	500	$ 5,000	
Total Firm Registration Fees			$ 71,000	
Agents				
Number of Agents		4		
FINRA Agent Licensing Fees @	$	85	$ 340	
Agent Licensing Fees (Average Estimate Per State) @	$	50	$ 2,000	
Agent Renewal Fees	$	50	$ 2,000	
Exams	$	75	$ 300	
Fingerprinting	$	32	$ 128	
Total Agent Registration Fees			$ 4,768	
Total Regulatory and FINRA Specific Operating Fees			$ 75,768	
Consulting, Legal & Accounting Fees				
Legal Fee (incorporation and business fees)			$ 1,500	
Compliance Consulting Fee at $500/mo			$ 6,000	
CPA Consulting Fees			$ 7,500	
Annual CEO Compliance Certification			Variable	
Annual Supervisory Controls Testing and Certification			Variable	
Anti-money Laundering Program Testing (three-year cycle)			Variable	
			$ 15,000	
FINRA Initial New Member Application Consulting Fees			$ 20,000	Estimated number, may be more or less based on complexity of business
Total Consulting, Legal and Accounting			$ 35,000	
Total Estimated Regulatory/Consulting Costs			$ 278,536	

Exhibit 3

FINRA Gross Income Assessments and Various Registration Fees

Regulatory Notice 09-68

Regulatory Pricing Changes

SEC Approves Changes to the Personnel Assessment and Gross Income Assessment Fees

Effective Date: January 1, 2010

Executive Summary

The SEC has approved changes to FINRA's regulatory pricing structure as originally outlined in *Regulatory Notice 09-56* (September 2009). Effective January 1, 2010, FINRA will implement a new Personnel Assessment rate structure and a revised calculation for the Gross Income Assessment.[1]

The text of the amendments to Schedule A of the FINRA By-Laws is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Finance at (240) 386-5397; or
- the Office of General Counsel at (202) 728-8071.

Background and Discussion

FINRA's primary pricing structure consists of the following fees: the Personnel Assessment (PA), the Gross Income Assessment (GIA), the Trading Activity Fee and the Branch Office Assessment. These fees are used to fund FINRA's regulatory activities, including its examination and enforcement programs. The SEC has approved a rule change that restructures the PA and the GIA to allow FINRA to continue to effectively discharge its regulatory obligations in a fiscally prudent way, while reducing its vulnerability to another market downturn.

November 2009

Notice Type
- Rule Amendments

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topic(s)
- Gross Income Assessment
- Personnel Assessment
- Regulatory Fees

Referenced Rules & Notices
- Regulatory Notice 08-19
- Regulatory Notice 09-56
- Sections 1 and 2 of Schedule A of FINRA By-Laws

FINRA
Financial Industry Regulatory Authority

The GIA currently is assessed through a seven-tiered rate structure with a minimum GIA of $1,200. Under the current pricing structure, firms are required to pay an annual GIA as follows:

(1) $1,200 on annual gross revenue up to $1 million;

(2) 0.1215% of annual gross revenue greater than $1 million up to $25 million;

(3) 0.2599% of annual gross revenue greater than $25 million up to $50 million;

(4) 0.0518% of annual gross revenue greater than $50 million up to $100 million;

(5) 0.0365% of annual gross revenue greater than $100 million up to $5 billion;

(6) 0.0397% of annual gross revenue greater than $5 billion up to $25 billion; and,

(7) 0.0855% of annual gross revenue greater than $25 billion.

The rule change amends Schedule A of the FINRA By-Laws to assess a GIA of the greater of (1) the amount that would be the GIA based on the existing rate structure (current year GIA) or (2) a three-year average of the GIA to be calculated by adding the current-year GIA plus the GIA assessed on the firm over the previous two calendar years, divided by three. For a newer firm that has only been assessed in the prior year, FINRA will compare the current year GIA to the firm's two-year average and assess the greater amount.

Otherwise, the existing GIA rate structure and phase-in implementation through 2010 remain the same. Thus, for 2010, the current year GIA would remain subject to the cap set forth in *Regulatory Notice 08-19* (April 2008), which describes the new funding structure that resulted from the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA. FINRA states in the *Notice* that it will apply a 10 percent cap on any increase or decrease of a firm's 2010 current year GIA resulting from the new pricing structure implemented in January 2008.[2]

Firms should note that FINRA is committed to its practice of providing rebates to firms when revenues exceed the expenditures necessary to discharge its regulatory obligations.

The rule change also increases the PA to better align FINRA's revenues with its costs. The PA is currently assessed on a three-tiered rate structure: firms with one to five registered representatives and principals are assessed $75 for each registered person; 6 to 25 registered persons, $70 each; and 26 or more registered persons, $65 each. The rule change increases those rates to $150, $140 and $130, respectively, based on the same tiered structure.

Implementation

The rule changes are effective **January 1, 2010**.

Endnotes

1 *See* Exchange Act Release No. 61042 (November 20, 2009), 74 FR 62616 (November 30, 2009) (Order Approving SR-FINRA-2009-057).

2 The actual amount of GIA assessed in any given year—*e.g.*, the capped amount or the three-year average—will be used to calculate subsequent three-year average determinations. The caps, if applicable, would be applied to the current-year assessment and the resulting number would be used to calculate the three-year average.

Attachment A

Below is the text of the rule change. New language is underlined; deletions are in brackets.

* * * * *

SCHEDULE A TO THE BY-LAWS OF THE CORPORATION

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of the Corporation shall be determined on the following basis.

* * * * *

Section 1 — Member Regulatory Fees

(a) through (b) No Change.

(c) Each member shall pay an annual Gross Income Assessment equal to the greater [total] of:

(1) the total of:

[(1)](A) $1,200.00 on annual gross revenue up to $1 million;

[(2)](B) 0.1215% of annual gross revenue greater than $1 million up to $25 million;

[(3)](C) 0.2599% of annual gross revenue greater than $25 million up to $50 million;

[(4)](D) 0.0518% of annual gross revenue greater than $50 million up to $100 million;

[(5)](E) 0.0365% of annual gross revenue greater than $100 million up to $5 billion;

[(6)](F) 0.0397% of annual gross revenue greater than $5 billion up to $25 billion; and

[(7)](G) 0.0855% of annual gross revenue greater than $25 billion[.]; or

(2) The average Gross Income Assessment from the preceding three calendar years, to be determined by adding the Gross Income Assessment calculation pursuant to paragraph (c)(1) to the actual Gross Income Assessment in the preceding two calendar years, then dividing by three.

The rate structure set forth in paragraph (c)(1) [above] will be implemented over a three year period beginning in 2008 in such manner as specified by FINRA.

For the purpose of paragraph (c)(1), [E]each member is to report annual gross revenue as defined in Section 2 of this Schedule[,] for the preceding calendar year.

(d) Each member shall pay an annual Personnel Assessment equal to:

(1) [$75]$150.00 per principal and each representative up to five principals and representatives as defined below;

(2) [$70]$140.00 per principal and each representative for six principals and representatives up to twenty-five principals and representatives as defined below; or

(3) [$65]$130.00 per principal and each representative for twenty-six or more principals and representatives as defined below.

A principal or representative is defined as a principal or representative in the member's organization who is registered with FINRA as of December 31st of the prior fiscal year.

* * * * *

FINRA

Industry Professionals > Compliance > Registration > CRD > Filing & Guidance

2013 Registration Fees

The information provided below includes fee changes and their effective dates, which were approved by the U.S. Securities and Exchange Commission in June 2012 as noted in Regulatory Notice 12-32.

Membership Fee

Effective 7/23/12

The New Member Application (NMA) fee structure assesses fees ranging from $7,500 to $55,000 depending on the size of the new member applicant, as outlined in the tables below. The fee structure also assesses an additional $5,000 surcharge for a new member firm applicant that intends to engage in clearing and carrying activities.

Number of Registered Persons Associated With Applicant	Small	Medium	Large
Tier 1	1-10	151-300	501-1,000
Tier 2	11-100	301-500	1,001-5,000
Tier 3	101-150	N/A	>5,000

Application Fee per Tier	Small	Medium	Large
Tier 1	$7,500	$25,000	$35,000
Tier 2	$12,500	$30,000	$45,000
Tier 3	$20,000	N/A	$55,000

General Registration Fees

Effective 1/02/13

Fee	Description
$100.00	Registration Fee – for each initial Form U4. The following discounts apply to Forms U4 filed to transfer the registration of representatives/principals in connection with acquisition of all/part of a member's business by another member: • 1,000–1,999 registered personnel transferred – 10% discount • 2,000–2,999 registered personnel transferred – 20% discount • 3,000–3,999 registered personnel transferred – 30% discount • 4,000–4,999 registered personnel transferred – 40% discount • 5,000 and over registered personnel transferred – 50% discount
$45.00	Annual Web CRD Processing Fee
$110.00	Disclosure Processing Fee (U4, U5 & amendments) – for all registration, transfer or termination filings with new or amended disclosure information or that require certification as well as any amendment to disclosure information.
$100.00 for the first day, $25 for each subsequent day, up to a	Late Disclosure Fee

maximum of 60 days. $1,575 max	
$40.00	Termination Fee
$80.00	Late Termination Fee

Branch Office Registration Fees

Fee Per Branch Office	Description
$75	Branch Office Initial Registration Fee
$20	Branch Office System Processing Fee

Notes about Branch Office Fees:

- FINRA will continue to waive the Initial Registration Fee for one branch per firm.
- FINRA will continue to waive the System Processing Fee for one branch per firm.

Branch Office Annual Registration Fees (Renewal)

Effective 1/02/13

# of Branch Offices	Fee Per Branch Office
1-250	$175
251-500	$150
501-1000	$125
1001-2000	$100
2001+	$75

Notes about Branch Office Fees:

- FINRA will continue to waive the Annual Registration Fee (renewal) for one branch per firm.
- In addition to the Annual Registration Fee, FINRA will continue to assess a $20 Annual System Processing Fee (renewal) per branch office.
- FINRA will continue to waive the Annual System Processing Fee (renewal) for one branch per firm.

Fingerprint Processing Fees

Effective 1/02/13

Electronic Submission – covers processing and posting to Web CRD

Fee Per Submission	Description
$29.50	Initial Submission
$15.00	Second Submission for a first fingerprint submission that was deemed illegible by the FBI
$29.50	Third Submission

Paper Card Submission – covers processing and posting to Web CRD

Fee Per Card	Description

$44.50	Initial Submission
$30.00	Second Submission for a first fingerprint submission that was deemed illegible by the FBI
$44.50	Third Submission

Qualification Examination Fees are listed on the FINRA Administered Qualification Examinations table.

Last Updated: 11/21/2012

FINRA

Print

Section 4 — Fees

(a)(1) Each member shall be assessed a registration fee of $75.00 and a branch office system processing fee of $20.00 upon the registration of each branch office, as defined in the By-Laws.

(2) FINRA shall waive, for the first branch office registered by a member, payment of the $75.00 registration fee and the $20.00 branch office system processing fee (where such fees have been assessed pursuant to paragraph (a)(1)).

(3) Each member also shall be assessed:

(A) an annual registration fee of:

(i) $175, for each of the first 250 branch offices registered by the member;

(ii) $150, for each of branch offices 251 to 500 registered by the member;

(iii) $125, for each of branch offices 501 to 1,000 registered by the member;

(iv) $100, for each of branch offices 1,001 to 2,000 registered by the member;

(v) $75, for every branch office greater than 2,000 registered by the member; and

(B) an annual branch office system processing fee of $20.00 per registered branch.

(4) FINRA shall waive, for one branch office per member per year, payment of the $175 annual registration fee (where such fee has been assessed pursuant to paragraph (a)(3)(A)(i) and the $20.00 annual branch office system processing fee assessed pursuant to paragraph (a)(3)(B).

(b) FINRA shall assess each member a fee of:

(1) $100.00 for each initial Form U4 filed by the member with FINRA for the registration of a representative or principal, except that the following discounts shall apply to the filing of Forms U4 to transfer the registration of representatives or principals in connection with acquisition of all or a part of a member's business by another member:

Number of Registered Personnel Transferred	Discount
1,000–1,999	10%
2,000–2,999	20%
3,000–3,999	30%
4,000–4,999	40%
5,000 and over	50%

(2) $40.00 for each initial Form U5 filed by the member with FINRA for the termination of a registered representative or registered principal, plus a late filing fee of $80.00 if the member fails to file the initial Form U5 within 30 days after the date of termination;

(3) $110.00 for the additional processing of each initial or amended Form U4, Form U5 or Form BD that includes the initial reporting, amendment, or certification of one or more disclosure events or proceedings;

(4) $15.00 for processing and posting to the CRD system each set of fingerprints submitted electronically by the member to FINRA, plus any other charge that may be imposed by the United States Department of Justice for processing each set of fingerprints;

(5) $30.00 for processing and posting to the CRD system each set of fingerprint cards submitted in non-electronic format by the member to FINRA, plus any other charge that may be imposed by the United States Department of Justice for processing each set of fingerprints;

(6) $30.00 for processing and posting to the CRD system each set of fingerprint results and identifying information that have been processed through another self-regulatory organization and submitted by a member to FINRA;

(7) $45.00 annually for each of the member's registered representatives and principals for system processing; and

(8) 10% of a member's final annual renewal assessment or $100, whichever is greater, with a maximum charge of $5,000, if the member fails timely to pay the amount indicated on its preliminary annual renewal statement.

(c) The following fees shall be assessed to each individual who registers to take an examination as described below. These fees are in addition to the registration fee described in paragraph (b) and any other fees that the owner of an examination that FINRA administers may assess.

Series 4	Registered Options Principal	$100
Series 6	Investment Company Products/Variable Contracts Representative	$95
Series 7	General Securities Representative	$290
Series 9	General Securities Sales Supervisor — Options Module	$75
Series 10	General Securities Sales Supervisor — General Module	$120
Series 11	Assistant Representative — Order Processing	$75
Series 14	Compliance Official	$335
Series 16	Supervisory Analyst	$230
Series 17	Limited Registered Representative	$75
Series 22	Direct Participation Programs Representative	$95
Series 23	General Securities Principal Sales Supervisor Module	$95

Series 24	General Securities Principal	$115
Series 26	Investment Company Products/Variable Contracts Principal	$95
Series 27	Financial and Operations Principal	$115
Series 28	Introducing Broker-Dealer Financial and Operations Principal	$95
Series 37	Canada Module of S7 (Options Required)	$175
Series 38	Canada Module of S7 (No Options Required)	$175
Series 39	Direct Participation Programs Principal	$90
Series 42	Registered Options Representative	$70
Series 51	Municipal Fund Securities Limited Principal	$95
Series 52	Municipal Securities Representative	$120
Series 53	Municipal Securities Principal	$105
Series 55	Limited Representative — Equity Trader	$105
Series 62	Corporate Securities Limited Representative	$90
Series 72	Government Securities Representative	$105
Series 79	Investment Banking Qualification Examination	$290
Series 82	Limited Representative — Private Securities Offering	$90
Series 86	Research Analyst — Analysis	$175
Series 87	Research Analyst — Regulatory	$125
Series 99	Operations Professional	$125

(1) Persons for whom any qualification examination is waived pursuant to Rule 1070 shall be assessed as an application fee the examination fee for each qualification examination so waived.

(2) There shall be an additional service charge of $15.00 for any examination or Regulatory Element session taken in a test center located outside the territorial limits of the United States.

(3) There shall be a service charge equal to the examination or Regulatory Element session fee assessed to each individual who, having made an appointment for a specific time and place for computer-based administration of an examination listed above or Regulatory Element session, fails to timely appear for such appointment or cancels or reschedules such appointment within two business days prior to the appointment date.

(4) There shall be a service charge equal to one-half of the examination or Regulatory Element session fee assessed to each individual who, having made an appointment for a specific time and place for computer-based administration of an examination listed above or Regulatory Element session, cancels or reschedules such appointment three to 10 business days prior to the appointment date.

(d) In the event a member believes it should not be required to pay the late filing fee, it shall be entitled to a hearing in accordance with the procedures set forth in the Rule 9640 Series.

(e)(1) In addition to any dues or fees otherwise payable, each applicant for membership shall be assessed an application fee, based on the number of registered persons proposed to be associated with the applicant at the time the application is filed, as outlined in the tables below:

Number of Registered Persons Associated with Applicant	Small	Medium	Large
Tier 1	1–10	151–300	501–1,000
Tier 2	11–100	301–500	1,001–5,000
Tier 3	101–150	N/A	>5,000

Application Fee per Tier	Small	Medium	Large
Tier 1	$7,500	$25,000	$35,000
Tier 2	$12,500	$30,000	$45,000
Tier 3	$20,000	N/A	$55,000

(2) Each applicant for membership also shall be assessed an additional $5,000 if the applicant will be engaging in any clearing and carrying activity.

(f) There shall be a session fee of $100 assessed as to each individual who is required to complete the Regulatory Element of the Continuing Education Requirements pursuant to FINRA rules.

(g)(1) Unless a specific temporary extension of time has been granted, there shall be imposed upon each member required to file reports, as designated by this paragraph ("Designated Reports"), a fee of $100 for each day that such report is not timely filed. The fee will be assessed for a period not to exceed 10 business days. Requests for such extension of time must be submitted to FINRA at least three business days prior to the due date; and

(2) Any report filed pursuant to this Rule containing material inaccuracies or filed incompletely shall be deemed not to have been filed until a corrected copy of the report has been resubmitted.

(3) List of Designated Reports:

(A) SEA Rule 17a-5 — Monthly and quarterly FOCUS reports and annual audit reports;

(B) SEA Rule 17a-10 — Schedule I;

(C) FINRA Rule 4140 — any audited financial and/or operational report or examination report required pursuant to Rule 4140; and

(D) FINRA Rule 4521 — any report, notification or information required pursuant to Rule 4521.

(h) FINRA shall assess each member a fee of $100.00 on the first day and $25.00 for each subsequent day, up to a maximum of $1,575, that a new disclosure event or a change in the status of a previously reported disclosure event is not timely filed as required by FINRA on an initial Form U5, an amendment to a Form U5, or an amendment to a Form U4, with such fee to be assessed starting on the day following the last date on which the event was required to be reported.

(i)(1) In addition to any dues or fees otherwise payable, each applicant submitting an application for approval of a change in ownership, control, or business operations shall be assessed an application fee, based on the number of registered persons associated with the applicant (including registered persons proposed to be associated with the applicant upon approval of the application) at the time the application is filed and the type of change in ownership, control, or business operations, as outlined in the tables below:

Number of Registered Persons Associated with Applicant	Small	Medium	Large
Tier 1	1–10	151–300	501–1,000
Tier 2	11–100	301–500	1,001–5,000
Tier 3	101–150	N/A	>5,000

Application Fee per Tier	Small	Medium	Large
Merger			
Tier 1	$7,500	$25,000	$50,000
Tier 2	$12,500	$30,000	$75,000
Tier 3	$20,000	N/A	$100,000
Material Change			
Tier 1	$5,000	$20,000	$35,000
Tier 2	$10,000	$25,000	$50,000
Tier 3	$15,000	N/A	$75,000
Ownership Change	$5,000	$10,000	$15,000
Transfer of Assets	$5,000	$10,000	$15,000

Acquisition	$5,000	$10,000	$15,000

(2) If an applicant's application for approval of a change in ownership, control, or business operations involves more than one type of application identified in the "application fee per tier and application type" table in paragraph (i)(1) of this section, the application fee shall be the highest amount of the applicable fees (e.g., the application fee for an applicant associated with 1–10 registered persons filing an application involving a merger and material change would be $7,500).

(3) FINRA shall waive the fee assessed pursuant to paragraph (i)(1) for a continuing membership application where FINRA determines that such application is proposing less significant changes that do not require substantial staff review. For example, a continuing membership application may qualify for a fee waiver under this paragraph (i)(3) where the proposed change:

(A) does not make any day-to-day changes in the applicant's business activities, management, supervision, assets, or liabilities, and the applicant is only proposing a change in the:

(i) applicant's legal structure (e.g., changing from a corporation to an LLC);

(ii) equity ownership, partnership capital, or other ownership interest in an applicant held by a corporate legal structure that is due solely to a reorganization of ownership or control of the applicant within the corporate legal structure (e.g., reorganizing only to add a holding company to the corporate legal structure's ownership or control chain of the applicant); or

(iii) percentage of ownership interest or partnership capital of an applicant's existing owners or partners resulting in an owner or partner owning or controlling 25 percent or more of the ownership interest or partnership and that owner or partner has no disclosure or disciplinary issues in the preceding five years; or

(B) is filed in connection with a direct or indirect acquisition or transfer of 25 percent or more in the aggregate of the applicant's assets or any asset, business, or line of operation that generates revenues composing 25 percent or more in the aggregate of the applicant's earnings, measured on a rolling 36-month basis, where the applicant also is ceasing operations as a broker or dealer (including filing a Form BDW with the SEC); and there are either:

(i) no pending or unpaid settled customer related claims (including, but not limited to, pending or unpaid settled arbitration or litigation actions) against the applicant or any of its associated persons; or

(ii) pending or unpaid settled customer related claims (including, but not limited to, pending or unpaid settled arbitration or litigation actions) against the applicant or its associated persons, but the applicant demonstrates in the continuing membership application its ability to satisfy in full any unpaid customer related claim (e.g., sufficient capital or escrow funds, proof of adequate insurance for customer related claims).

Amended by SR-FINRA-2013-015 eff. Feb. 5, 2013.
Amended by SR-FINRA-2012-030 eff. Jan. 2, 2013.
Amended by SR-FINRA-2012-031 eff. Jan. 2, 2013.
Amended by SR-FINRA-2012-031 eff. July 23, 2012.
Amended by SR-FINRA-2012-009 eff. Apr. 2, 2012.
Amended by SR-FINRA-2011-042 eff. Oct. 17, 2011.
Amended by SR-FINRA-2011-026 eff. Sept. 1, 2011.
Amended by SR-FINRA-2010-016 eff. April 9, 2010.
Amended by SR-FINRA-2008-067 eff. Feb. 8, 2010.
Amended by SR-FINRA-2009-071 eff. Jan. 4, 2010.
Amended by SR-FINRA-2009-056 eff. Nov. 2, 2009.
Amended by SR-FINRA-2008-053 eff. Jan. 2, 2009.
Amended by SR-FINRA-2008-001 eff. Jan. 1, 2008.
Amended by SR-FINRA-2008-035 eff. July 30, 2007.
Amended by SR-NASD-2006-065 eff. July 3, 2006.
Amended by SR-NASD-2005-133 eff. Jan. 1, 2006.
Amended by SR-NASD-2005-132 eff. Jan. 1, 2006.
Amended by SR-NASD-2004-145 eff. Jan. 1, 2005.
Amended by SR-NASD-2004-087 eff. June 7, 2004.
Amended by SR-NASD-2004-049 eff. Mar. 30, 2004.
Amended by SR-NASD-2003-192 eff. Feb. 11, 2004.
Amended by SR-NASD-2004-115 eff. Jan. 1, 2004.
Amended by SR-NASD-2003-148 eff. Oct. 3, 2003.

Amended by SR-NASD-2003-109 eff. July 10, 2003.
Amended by SR-NASD-2002-182 eff. Dec. 24, 2002.
Amended by SR-NASD-2002-147 eff. Oct. 18, 2002.
Amended by SR-NASD-2002-100 eff. July 25, 2002.
Amended by SR-NASD-2002-98 eff. July 24, 2002.
Amended by SR-NASD-00-39 eff. Sept. 10, 2001.
Amended by SR-NASD-99-38 eff. Sept. 15, 1999.
Amended by SR-NASD-99-43 eff. Sept. 7, 1999.
Amended by SR-NASD-98-77 eff. Jan 1, 1999.
Amended by SR-NASD-98-95 eff. Dec 21, 1998.
Amended by SR-NASD-96-53 eff. Jan 3, 1997.
Amended by SR-NASD-95-32 eff. July 26, 1995.
Amended by SR-NASD-95-23 eff. July 1, 1995.
Amended by SR-NASD-94-58 eff. Dec. 9, 1994.
Amended by SR-NASD-94-06 eff. Feb. 9, 1994.
Amended by SR-NASD-94-05 eff. Jan. 21, 1994.
Schedule A, Sec. 2 amended eff. May 20, 1975; May 30, 1979; Oct. 1, 1979; Nov. 23, 1982; Oct. 1, 1985; Aug. 14, 1987; Apr. 4, 1990 (eff. May 1, 1990); May 3, 1990; Aug. 13, 1990; Mar. 1, 1991; July 16, 1991; Nov. 4, 1992; July 13, 1993.

Selected Notices: 95-59, 98-89; 99-75, 01-54, 04-25, 08-61, 09-67, 09-71, 11-36, 12-16, 12-32, 13-11.

FINRA

Industry Professionals > Compliance > Registration > Qualifications & Exams

FINRA Administered Qualification Examinations

Study outlines for some exams may be accessed by clicking on the Series number(s) listed below. Please click on the Series 63, 65, and 66 links to access study outlines available on the NASAA website, the Series 56 link to access the study outline available on the CBOE website and the Series 3 link to access the study outline available on the NFA website.

Series	Examination	Questions	Time (minutes)	Prerequisite	Cost
3	National Commodity Futures (CR)	120	150	None	$115
4	Registered Options Principal (OP)	125	180	S7, or S62 with S42, S17, S37 or S38	$100
6	Investment Company Products/Variable Contracts Representative (IR)	100	135	None	$95
7	General Securities Representative (GS)	250	360	None	$290
9	General Securities Sales Supervisor (Options Module (FINRA-SU)	55	90	S7	$75
10	General Securities Sales Supervisor General Module (FINRA-SU)	145	240	S7	$120
11	Assistant Representative-Order Processing (AR)	50	60	None	$75
14	Compliance Officer (NYSE-CO)	110	180	None	$335
16 Effective 10/28/13	Supervisory Analyst (NYSE-SA) [one or two parts depending on NYSE requirements]	Each Part 50	90 Part 1 120 Part 2	None	$230

17	Limited Registered Representative (IE)	100	150	FCA Registration	$75
22	Direct Participation Programs Representative (DR)	100	150	None	$95
23	General Securities Principal Sales Supervisor Module (GP)	100	150	S8, S9/10, or S12	$95
24	General Securities Principal (GP)	150	225	S7, S17, S37, S38, S62, S79 or S82	$115
26	Investment Company Products/Variable Contracts (IP)	110	165	S6 or S7	$95
27	Financial and Operations Principal (FN)	145	210	None	$115
28	Introducing Broker/Dealer Financial and Operations Principal (FI)	95	120	None	$95
30	NFA Branch Managers Examination	50	60	None	$75
31	Futures Managed Funds Examination	45	60	None	$75
32	Limited Futures Exam-Regulations	35	45	None	$75
34	Retail Off-Exchange Forex Examination	40	60	None	$75
37	Canada Module of S7 (CD) [Options Required]	90	150	CAN Registration	$175
38	Canada Module of S7 (CN) [No Options Required]	45	75	CAN Registration	$175
39	Direct Participation Programs Principal (DP)	100	135	S22 or S7	$90

42	Registered Options Representative (OR)	50	90	S72 or S62	$70
51	Municipal Fund Securities Limited Principal (FP)	60	90	S24 or S26	$155
52	Municipal Securities Representative (MR)	115	210	None	$180
53	Municipal Securities Principal (MP)	100	180	S52 or S7 (if passed prior to 11/7/11)	$165
55	Limited Representative-Equity Trader Examination (ET)	100	180	S7, S17, S37, S38, or S62	$105
56	Proprietary Trader Examination (PT)	100	150	None	$195
62	Corporate Securities Limited Representative (CS)	115	150	None	$90
63	Uniform Securities Agent State Law Exam (AG)	60	75	None	$115
65	NASAA-Investment Advisors Law Exam (RA)	130	180	None	$155
66	NASAA-Uniform Combined State Law Exam (AG and/or RA)	100	150	S7	$145
72	Government Securities Representative (RG)	100	180	None	$105
79	Limited Representative - Investment Banking	175	300	None	$290
82	Limited Representative-Private Securities Offerings (PR)	100	150	None	$90
86	Research Analyst (RS) Part I Analysis Module	100	240	S7 , S17, S37, or S38	$175

87	Research Analyst (RS) Part II Regulations Module	50	90	S7 , S17, S37, or S38	$125
91	FDIC Risk Management Technical Evaluation	100	240		$140
92	FDIC Compliance Technical Evaluation	100	240		$140
93	FDIC Division of Resolutions & Receivership Technical Evaluation	100	240		$125
99	Operations Professional (OS)	100	150	None	$125

Last Updated: 8/26/2013

SRO/Jurisdiction Fee and Setting Schedule - Web CRD

Fees As Of 10/4/2013

	Individual Fees					Individual Settings				BD Fees and Settings									
	Initial Reg Fee	Transfer / Relicense Fee*	Renewal Fee	Mass Transfer Fee	Mass Transfer Dual AG/RA Fee	Registration Review Method	Dual AG	Dual AG/RA	S63 Requirement	BD Initial Reg Fee	BD Renewal Fee	Branch Reqmt	Branch Office Fee	BR Renewal Fee	Form BR Amd Fee	Dual BR Office Fee	Dual BR Renewal Fee:	Branch Mass Tran Fee	Branch Mass Tran Dual Fee
Alabama	60	60	60	60		Automatic	Affiliates Only	Always	Yes	250	250	Notice File	0	0		0	0	0	
Alaska	75	75	75	75		Automatic	Never	Never	Yes	250	250	Notice File	0	0		0	0	0	
Arizona	45	45	45	45		Home State	Affiliates Only	Always	Yes	300	300	Neither						0	
Arkansas	75	75	75	75		Automatic	Affiliates Only	Affiliates Only	Yes	300	300	Register	50	50		100	100	50	100
California	25	25	0	25		Automatic	Always	Always	Yes	300	75	Neither						0	
Colorado	16	16	16			Automatic	Always	Always	No	80	80	Neither							
Connecticut	100	100	100	50		Automatic	Affiliates Only	Always	Yes	315	190	Register	100	0	100	200	0	100	
Delaware	65	65	65	65	130	Automatic	Always	Always	Yes	300	300	Neither						0	
District of Columbia	45	45	45			Automatic	Affiliates Only	Always	No	250	250	Neither							
Florida	50	50	50			Automatic	Always	Always	No	200	200	Register	100	100		200	200		
Georgia	50	30	40			Automatic	Always	Always	Yes	250	100	Neither							
Hawaii	^ 50	^ 50	25	^ 50	^ 75	Automatic	Always	Always	Yes	^ 200	100	Notice File	0	0		0	0	0	
Idaho	50	50	50			Automatic	Always	Always	Yes	200	200	Notice File	0	0		0	0		
Illinois	150	150	150	150		Automatic	Always	Always	Yes	600	600	Notice File	20	20		20	20	0	
Indiana	25	25	25	25	25	Automatic	Never	Always	Yes	250	125	Notice File	0	0					
Iowa	40	40	40	40		Automatic	Affiliates Only	Always	Yes	200	200	Neither						0	
Kansas	55	55	55	55		Automatic	Affiliates Only	Always	Yes	200	200	Notice File	0	0		0	0	0	
Kentucky	50	50	50	50	100	Automatic	Affiliates Only	Affiliates Only	Yes	120	120	Neither							
Louisiana	60	60	60			Automatic	Affiliates Only	Always	No	250	250	Neither							
Maine	50	50	30	50		Home State	Affiliates Only	Always	Yes	250	250	Register	50	30		50	30	50	50
Maryland	35	35	35	35	85	Automatic	Always	Always	No	250	250	Neither						0	0
Massachusetts	75	75	75	75		Automatic	Never	Always	Yes	450	450	Neither						0	
Michigan	65	65	65	65	65	Automatic	Affiliates Only	Always	Yes	300	300	Neither	0	0				0	0
Minnesota	50	25	50			Automatic	Affiliates Only		Yes	200	200	Neither							
Mississippi	50	50	50			Automatic	Always	Always	Yes	200	200	Neither							
Missouri	50	50	50	50	50	Automatic	Affiliates Only	Affiliates Only	Yes	200	100	Neither						0	
Montana	50	50	50	50		Automatic	Always	Always	Yes	200	200	Neither						0	
Nebraska	40	40	40	40		Automatic	Never	Always	Yes	250	250	Neither						0	
Nevada	125	125	125			Automatic	Never	Always	Yes	300	300	Register	100	100	50				
New Hampshire	130	130	100	25		Automatic	Affiliates Only	Always	Yes	300	250	Notice File						0	
New Jersey	60	60	60	60	60	Automatic	Always	Always	No	300	300	Neither						0	
New Mexico	50	50	50	50		Automatic	Affiliates Only	Always	Yes	300	300	Notice File	0	0		0	0	0	
New York	70	60	37	30		Automatic	Always		Yes	300	300	Neither						0	
North Carolina	125	125	125	125		Manual	Never	Always	Yes	300	300	Neither							
North Dakota	60	60	60	60		Automatic	Always	Always	Yes	200	200	Neither						0	
Ohio	60	60	60	15	30	Manual	Never	Always	No	200	200	Notice File	0	0		0	0		
Oklahoma	50	50	50	10		Automatic	Always	Always	Yes	300	300	Neither						0	
Oregon	60	55	55			Automatic	Never	Never	Yes	250	250	Neither							
Pennsylvania	120	120	105	120	120	Automatic	Never	Always	Yes	500	500	Neither						0	
Puerto Rico	150	150	150	150	150	Automatic	Affiliates Only	Affiliates Only	No	500	500	Neither						0	
Rhode Island	75	75	75	75	135	Automatic	Always	Always	Yes	300	300	Notice File	100	100				100	

Current change(s) in (^ Green)

	Individual Fees					Individual Settings				BD Fees and Settings									
	Initial Reg Fee	Transfer / Relicense Fee*	Renewal Fee	Mass Transfer Fee	Mass Transfer Dual AG/RA Fee	Registration Review Method	Dual AG	Dual AG/RA	S63 Requirement	BD Initial Reg Fee	BD Renewal Fee	Branch Reqmt	Branch Office Fee	BR Renewal Fee	Form BR Amd Fee	Dual BR Office Fee	Dual BR Renewal Fee:	Branch Mass Tran Fee	Branch Mass Tran Dual Fee
South Carolina	110	110	110	110		Automatic	Affiliates Only	Affiliates Only	Yes	310	310	Neither						0	
South Dakota	125	125	125	125		Automatic	Affiliates Only	Affiliates Only	Yes	150	150	Notice File	0	0		0	0	0	
Tennessee	50	50	50	50	100	Home State	Always	Always	Yes	200	200	Notice File	0	0		0	0		
Texas	285	285	275	285	285	Automatic	Always	Always	Yes	275	270	Register	25	25	25	25	25	25	25
Utah	60	60	60	60	110	Automatic	Never	Always	Yes	200	200	Neither							
Vermont	60	60	60	60		Home State	Affiliates Only	Always	No	250	250	Register	100	100				100	
Virgin Islands	50	50	50	50	50	Home State	Affiliates Only	Always	Yes	200	200	Register	100	100		100	100	100	100
Virginia	30	30	30	30		Automatic	Never	Always	Yes	200	200	Neither						0	
Washington	40	25	20	25		Automatic	Always	Always	Yes	150	75	Notice File	0	0		0	0	0	
West Virginia	80	80	65	80		Automatic	Never	Always	Yes	250	250	Notice File	50	50				50	
Wisconsin	80	80	80	80	160	Automatic	Affiliates Only	Always	Yes	400	200	Notice File	80	80		160	160	80	160
Wyoming	35	35	35			Automatic	Always		Yes	200	200	Neither							
ARCA	0	0	0			SuperAutomatic						Neither							
BATS-YX	0	0	0		0	SuperAutomatic				0	0								0
BATS-ZX	0	0	0		0	SuperAutomatic				0	0								0
BOX	0	0	0	0	0	SuperAutomatic				0	0		0	0				0	0
BX (BSE)	0	0	0			SuperAutomatic					3000	Neither							
C2	0	0	0			SuperAutomatic				0		Neither							
CBOE	0	0	0			SuperAutomatic				0		Neither							
CHX						SuperAutomatic						Neither							
EDGA	0	0	0	0	0	SuperAutomatic				0	2000		0	0				0	0
EDGX	0	0	0	0	0	SuperAutomatic				0	2000		0	0				0	0
FINRA	100	100	45	100		Automatic						Notice File	75	75-175				75	
ISE	0	0	0			SuperAutomatic						Neither							
NQX	55	55	0			SuperAutomatic				0	3000	Neither							
NSX						SuperAutomatic						Neither							
NYSE	0	0	0	0		SuperAutomatic						Register							
NYSE MKT	0	0	0			SuperAutomatic						Neither							
PHLX	0	0	0			SuperAutomatic						Neither							

FINRA Branch Office fees have a new tiered structure: $75-175 based on number of branches registered by the member. Note: FINRA will continue to waive the Branch Office System Processing Fee and Annual Branch Office Registration Fee for one branch office per FINRA member per year. For more info see FINRA Regulatory Notice 12-32 http://www.finra.org/Industry/Regulation/Notices/2012/P127240

Individual Registration Termination Fee: FINRA charges a $40 fee for individual registration termination.

Individual Registration Review Methods:

- For *jurisdictions*, the review method may be Manual, Automatic, or 'Home State'.
  - Home State - This is essentially the same as automatic, with the exception that applicants with a residential address in that jurisdiction will be reviewed manually.
- For SROs, the review method may be Manual, Automatic or SuperAutomatic.
  - SuperAutomatic - Regardless of whether there is any new or updated disclosure, a SuperAutomatic setting denotes that if an individual's registration request is non-deficient and is approved by Financial Industry Regulatory Authority, the individual's registration will also be approved by that SRO. With the same conditions, where there is no Financial Industry Regulatory Authority registration request, a non-deficient registration request will systematically approve with that SRO.

Dual Registrations:

- Always = dual registrations are permitted.
- Never = dual registrations are prohibited. Dual deficiencies will be applied. Please contact the state directly for any exceptions.
- Affiliates Only = Dual registrations are permitted for employment with affiliated firms. The term 'affiliate' is defined on Form U4 as any firm under common ownership or control. Dual deficiencies will be applied to requests for dual or multiple registrations with firms that are not affiliated. The system will not recognize firms as affiliated unless the filing firm reports the affiliated firm under Question 10A or 10B on the Form BD, or Item 7A(3) on the Form ADV.

Dual Branch Office Fee and Dual BR Renewal Fee – this fee will apply to branch offices filing as both BD and IA branches. The dual fee will apply in full when filing both sides (BD and IA) simultaneously. Should a branch already be filed as one of the two, the dual fee MINUS the fee already paid will apply. For example, if already filed as a BD branch, and then filing as an IA branch, the fee will be the dual fee minus the BD fee.

Exhibit 4

A Bipartisan Small Business Fix,
Michael Nall, AM&AA Founder
Posted to the Hill.com
October 8, 2013

THE HILL

THE HILL'S
Congress Blog
Where lawmakers come to blog

A bipartisan small business fix

By Michael Nall - 10/08/13 09:00 AM ET

As Congress confronts issues of tremendous policy and political implications in the next few weeks including a continuing resolution to keep the government open, federal debt ceiling debates, and numerous healthcare, immigration, and energy proposals, one bill is quietly making its way through Congress which is bipartisan, pro-small business, pro-job growth, and a long overdue fix for professionals who work in the sale of private businesses.

HR 2274, the Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013 is an excellent bipartisan bill, one whose time has come, and Congress should get it done before the end of the year. It's not a sexy bill, not one that prime-time TV will be talking about, and not one that will evoke a question in the next presidential debates, but it's a bill that does have teeth and it is a serious and substantive piece of small business legislation.

HR 2274 would simplify and reduce the costs of federal securities regulation in privately negotiated mergers and acquisitions. The bill would apply to M&A transactions involving the sale of private companies with earnings of less than $25 million (earnings are defined as EBITDA which stands for Earnings Before Interest, Taxes and Depreciation) and revenue of less than $250 million to active buyers.

The key words here are 'private companies' and 'active buyers.' It would direct the SEC to create a simplified system of registration through a public notice filing that would be available on the SEC's website, and it would require appropriate client disclosures from the M&A broker. H.R. 2274 would

also direct the SEC to tailor its rules governing M&A brokers in light of the limited scope of their activities, the nature of privately negotiated M&A transactions, and the active involvement of buyers and sellers in those transactions.

The current one-size-fits-all law treats the sale of a small, privately held business the same as a Wall Street investment banker selling securities of a public company. For instance, a sale of a local candy store with seller financing can technically be considered a securities transaction requiring broker-dealer registration with the SEC.

There is a big difference between the sale of a small business to a buyer who will be active in managing the business after the sale and the sale to passive investors of securities of a publicly-traded company on the New York Stock Exchange.

Current law does not distinguish between these two activities – and it should. It's time for Washington to define the differences.

HR 2274 does just that.

2274 would help small business owners reap the benefits of their entrepreneurial efforts of starting, building, and running a job creating private enterprise. For many of these owners, sale of their business is their retirement nest egg. 2274 also helps entrepreneurs and managers buy an existing business and build it up to the next level.

Compliance costs for small businesses associated with these current regulations can easily exceed $75,000 per year; costs that could result in either non-compliance or expenses passed on to the small business owners.

2274 would lower costs, increase compliance, and better serve buyers and sellers of small businesses. It is a bill that promotes economic development, job creation, and provides important, immediate, and substantial relief of regulatory burdens on small business professionals in the critical M&A industry.

In this red hot partisan atmosphere, perhaps Congress can take a day to identify and pass some truly bipartisan small business bills. Such an act would show America that, while major philosophical differences and contentious proposals are being hammered out on high-profile issues on Capitol Hill, at the same time, positive initiatives can still being considered and passed in a bipartisan fashion; laws that can make a real and immediate difference in the lives of many Americans.

It is a smart bill and one that deserves consideration through a straight-up vote or through inclusion in any other jurisdictional bills moving through Congress that address small business, jobs or regulatory reform.

We encourage Congress to look at 2274 as a perfect example of where Congress can come together in a bipartisan effort to show that things are still getting done for the American small business community in Washington.

Nall is the president of The Alliance of Merger & Acquisition Advisors® (amaaonline.org) which is the international organization serving the the middle market M&A industry.

Source:
http://thehill.com/blogs/congress-blog/economy-a-budget/326999-a-bipartisan-small-business-fix

Congressional Testimony H.R. 1800 AND H.R. 31
Written

Legislation to Further Reduce Impediments to Capital Formation

Small Business Credit Availability Act (H.R. 1800)
Next Steps for Credit Availability Act (H.R. 31)
Alexander C. Frank

As Chief Financial Officer and Partner of Fifth Street Management LLC, I appreciate the opportunity to testify on the implications of H.R. 1800 and H.R. 31. Fifth Street is an alternative asset manager with over $3 billion in assets under management and the SEC-registered investment adviser of two publicly-traded business development companies. Our team has a 15 year track record financing small and mid-sized companies, primarily in connection with investments by private equity sponsors.

BDCs like Fifth Street play an essential role in the new paradigm of middle market lending. As traditional banks have shied away from lending to small and mid-sized private businesses, alternative lenders like BDCs have filled the void, emerging as the primary conduit between banks and smaller companies that are non-investment grade credits. Consider that nine years ago, there were just four publicly-traded BDCs. Today, there are roughly ten times as many—or approximately 40 publicly-traded BDCs—and we estimate that within the next few years, BDC assets will eclipse $100 billion.

Despite the growing importance of BDCs in helping finance small and mid-sized companies in our economy today, the BDC industry is still burdened by legacy regulations that create an uneven playing field while needlessly costing the industry significant amounts of time and money each year. Since BDCs are pass-through vehicles, that cost is borne not just by BDC shareholders, but by the small businesses BDCs serve as well.

Several aspects of both H.R. 1800 and H.R. 31 could go a long way towards "modernizing the BDC regulatory framework." First, allowing BDCs to own interests in registered investment advisers is a shareholder-friendly step that would offer investors incremental fee-based revenue. Second, permitting BDCs to issue preferred equity that would be considered regulatory capital could be viewed as equally favorable—BDCs would gain a new source of funding, while investors would benefit from less dilution from additional issuance of common equity shares. Finally, if SEC registration is streamlined, BDCs should become more agile, tapping the capital markets more quickly and having the ability to pursue opportunities as they arise. The latter two provisions, in particular, will bring much-needed parity to the BDC industry vis a vis counterparts like REITs and MLPs.

Collectively, such modernization would represent a positive development for an industry that is playing an increasingly important role in financing underserved small and mid-sized U.S. companies. However,

when it comes to reducing asset coverage requirements—which would allow for more aggressive balance sheet leverage—H.R. 1800 and H.R. 31 may not be appropriate in all cases, or for all asset classes, and I believe requires further review. Prudently-managed BDCs with efficient operations simply are not challenged by a lack of capital today. In fact, the BDC industry as a whole witnessed a multitude of securities issuances in 2012 and that trend has continued into 2013.

Investment grade rated BDCs issued close to $1.3 billion in public equity for the full 2012 calendar year, a 300% increase compared with all of 2011.[1] With ample capital to deploy, well-run BDCs easily maintained leverage levels below statutory minimums—the industry's average debt/equity ratio stood at approximately 0.4x equity last year. According to Fitch Ratings, unsecured debt issuances totaled $1.9 billion across six rated BDCs in 2012 and 1Q13, versus just $545 million across three rated BDC issuers in 2011.[2]

In reality, the single biggest hurdle that prevents a BDC from attracting new capital is having a stock price that trades below net asset value (NAV), or book value. BDCs are not permitted to sell shares below net asset value without shareholder approval. Approval notwithstanding, the invisible hand of the market serves as a natural constraint against BDCs with discounted NAVs. It is difficult to successfully raise equity when one's stock (or, at times, the entire sector) is out of favor.

A number of factors influence a BDC's NAV, including dividend policy, the prospect for dilutive equity raises and above all, the credit performance of a BDC's underlying portfolio. On the latter front—under the existing leverage rules—the industry's overall track record has been strong. Cumulative realized and unrealized losses for the BDC industry average at a rate of around 70 basis points annualized, which compares favorably to a 257 basis points annualized rate for commercial banks.[3] Thus, while banks may gravitate toward more liquid assets, BDCs have demonstrated relatively superior credit performance.

Yet, there have still been notable exceptions. At the peak of the credit cycle in 2006-2007, two prominent BDCs overextended their debt capacity as a means of fueling aggressive portfolio growth. Unfortunately, the timing was disastrous. A series of write-downs led to violations of credit facility covenants, which resulted in restructurings and the eventual cessation of dividend payments. In the end, equity investors suffered considerable losses.

Several lessons can be learned from this cautionary tale. First, a few high-profile mistakes can tarnish the entire industry. This is especially true in a sector that tends to be viewed as a monolith—as evidenced by the fact that virtually the entire BDC industry trades in a narrow range in terms of price-to-book. The misguided decisions of two players who borrowed imprudently in pursuit of growth still haunt the industry today. As well-managed BDCs shake off the lingering pall of investor misconceptions, it would be counterproductive to raise the specter of expanded leverage.

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[1] "BDC Unsecured Issuance Bolstering Funding Flexibility," April 9, 2013. Fitch Ratings.

[2] Ibid.

[3] "The BDC Almanac–Part Deux," January 23, 2013. Wells Fargo Securities.

The second key lesson is the importance of having diversified sources of funding. Today, large BDCs enjoy multiple pockets of funding. This diversification reduces the likelihood of a potential liquidity squeeze. However, smaller BDCs may not be able to afford the luxury of varied funding sources. Even so, under current asset coverage requirements, it might still be feasible for a smaller BDC to approach the public equity markets to replace funding from a pulled credit line. Under the newly proposed guidelines, however, the potential hole could be too large to fill.

The final lesson that can be gleaned is that BDC investors place a high premium on stability. Investors in BDCs are attracted to the potential for healthy dividend yields with low leverage. It is that combination that makes the BDC model uniquely compelling: robust current income without undue risk. Because BDCs pay dividends based on the taxable income they earn, investors generally feel secure knowing that dividends are supported by relatively stable, predictable cash flows.

Today, the Securities & Exchange Commission does a highly effective job enforcing the current leverage ratio. In our view, the 1:1 ratio—and its strict SEC oversight—contributes to a reputation for safety that is appreciated by both BDC investors and nationally recognized rating agencies alike. Altering the leverage profile in the BDC model would inevitably lead to higher default risk—to the detriment of the investment calculus.

Investors are not the only ones who would likely feel compelled to re-evaluate the BDC model if leverage beyond the traditional 1:1 requirement is permitted. Rating agencies—instrumental in helping BDCs become a more entrenched institutional asset class—would likely view the development as unfavorable, too.

As nationally recognized ratings agencies incorporate the higher risk of defaults into their models, downgrades could follow. Even those BDCs who adopt a more conservative approach could be penalized, as agencies would need to account for potential competitive pressures to expand leverage.

A change in position could not come at a worse time for the industry. New risk-based capital weightings under Basel III are likely to mandate that banks increase equity capital reserves for leveraged loans. While many view this as a positive development for BDCs—assuming decreased bank competitiveness in the middle market space—potential credit downgrades could undercut any upside.

At best, a non-investment grade credit rating would increase a BDC's cost of capital on bank credit facilities. At worst, it could make institutional investors less receptive to BDCs at a time when an uptick in unsecured debt issuances is enhancing BDCs' funding diversity.

In short, credit downgrades would be an unwelcome surprise at a time when BDCs should be capitalizing on the tailwinds of supportive capital markets for unsecured debt and increased market share potential due to Basel III.

This discussion would not be complete without mentioning "effective leverage", which takes into account, on a look-through basis, leverage of the underlying assets in which a BDC invests. In other

words, it's important to recognize that BDCs often provide expansion capital to their portfolio companies who are often heavily leveraged themselves.

Effective leverage is an important concept because it shows the true risk in a BDC's balance sheet. Wells Fargo Securities, LLC estimates the BDC peer group average at 3.5x, but the most highly levered BDCs have effective leverage ratio estimates over 5.5x.[4] If H.R. 1800 or H.R. 31 is enacted in its current form, BDCs with already high levels of effective leverage could essentially double their effective leverage up to 11x.

Not all BDCs are alike—and 1:1 leverage may not be precisely the right level. Yet, a drastic move from 1:1 to 2:1 leverage in one step might benefit a handful of BDCs while working to the detriment of the vast majority. During this period of high growth and increasing small-business reliance on BDCs, completely removing the safety rails does not seem judicious. Having reduced the amount of risk in the financial system by requiring banks to hold more capital to support the risks associated with lending to non-investment grade companies—only to shift that risk to entities already operating more responsibly—appears imprudent and could significantly undermine the long-term vision that the bills set out to achieve.

The BDC industry stands at a crossroads: BDCs are considered an emerging asset class and the industry is growing swiftly. In fact, industry analysts see parallels between BDCs and two other investment vehicles, Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs), which also started out as relatively obscure, niche investments. Now, REITS and MLPs are highly successful, well-established asset classes. All indications are that BDCs could continue to provide very good investment opportunities—provided the industry avoids reputational damage and other hurdles that could undermine its prospects.

Many BDCs would welcome either H.R. 1800 or H.R. 31 as it is currently written, and three provisions seem both prudent and beneficial. However, from a fiduciary perspective and the protection of shareholder capital, increasing the leverage threshold potentially risks shrinking the pool of capital available to BDCs and choking off liquidity to the "young, rapidly growing companies" it is designed to help.

[4] (Wells Fargo Securities, The Q3 2013 BDC Scorecard, June 14, 2013, page 50)

Statement of the U.S. Chamber of Commerce

ON: **Legislative Proposals to Reduce Barriers to Capital Formation**

TO: **The Subcommittee on Capital Markets and Government Sponsored Enterprises**

BY: **Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness**

DATE: **October 23, 2013**

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney and Members of the Capital Markets and Government Sponsored Enterprises subcommittee, my name is Tom Quaadman and I am Vice President of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents.

Before I address the subject of the hearing, I would like to thank Chairman Garrett, Ranking Member Maloney and the Members of the Capital Markets and Government Sponsored Enterprises Subcommittee for your tireless efforts to improve capital formation opportunities for America's small and mid-size businesses. These efforts resulted in the enactment of the bi-partisan Jumpstart Our Business Startups Act ("JOBS Act") last year, and we hope that your current exertions will culminate in a JOBS Act II becoming law.

I. Need for Diverse Forms of Capital in a Free Enterprise System

In 2011, the Chamber released a study by Professor Anjan Thakor of Washington University entitled, ***Sources of Capital and Economic Growth: Interconnected and Diverse Markets Driving U.S. Competitiveness*** ("Thakor Study"). The Thakor Study found that a key factor for small business success and resulting growth and job creation is their ability to access financing. The Thakor Study had five key conclusions:

1. A robust, efficient and diverse financial system facilitates economic growth;

2. In terms of their financing choices individual entrepreneurs are largely limited to debt financing for raising capital;

3. As businesses grow they can access both debt and equity financing and the mix of these two, called the "capital structure" decision, is an important choice every business makes;

4. A rich diversity of financing sources is provided by the U.S. financial system; and

5. The U.S. financial system is highly connected and what happens to one financing source causes spillover effects in other parts of the system. So for example, if excessive regulation restricts access to, or the operation of, the IPO

and secondary markets for publicly traded companies, the resulting loss of liquidity will act as a disincentive to private equity and venture capital activity as well.

Therefore, the better the financial system functions, the more new companies are launched, the larger the number of publicly listed companies, the better overall management of risk and greater availability of consumer credit. In other words, a diverse, well-developed and efficient system of capital formation is necessary for robust economic growth and increased employment.

Over the past several years we have seen our capital markets lose efficiency with a resulting decline in the number of businesses becoming public companies, as well as a sharp drop in the number of public companies overall. Many reasons exist for these outcomes—the financial crisis, stale regulatory systems that fail to keep up with the needs of a 21st century economy, and legislative and regulatory initiatives that are changing fundamental practices that have been in place for decades.

What has not changed is the need for new businesses and growing businesses to acquire capital. However, if those capital needs are not met, the next big idea or next successful business will simply wither on the vine and blow away with the wind.

These bi-partisan bills are an important step in removing some of the roadblocks that are inhibiting growth by America's Main Street businesses. The Chamber supports these bills and I will offer some constructive changes as I discuss these legislative proposals in greater detail.

II. Legislative Proposals

a. Bills Regarding Business Development Companies

I would like to address the proposed legislation on Business Development Companies ("BDCs"), H.R. 31 offered by Ms. Velazquez, H.R. 1800 offered by Messer's. Grimm and Graves, and H.R. 1973 offered by Mr. Mulvaney, together as one package.

BDCs are a unique form of financing, similar to private equity, venture capital or Real Estate Investment Trusts. They have become increasingly popular as the credit cycle and regulatory reaction to the financial crisis have made accessing debt financing more challenging. It is important to keep in mind that BDCs are open to retail investors and not just accredited investors. BDCs tend to have higher yields, but also greater risks than fixed-income products.

The passage of H.R. 31, H.R. 1800, and H.R. 1973 would increase the capital available to BDCs and increase their ability to provide small and mid-size businesses with the funding needed to grow. Additionally, these bills would remove barriers for BDCs to become more active participants in the marketplace. For example, some BDCs could be treated as "well known seasoned issuers" and thus be permitted to issue securities more quickly. BDCs would be able to use a modestly higher level of leverage, which would permit them to invest more capital to portfolio companies. BDCs would also have more flexibility in their investments.

A combination of events and forces— Basel III, changes in risk tolerances, a zero rate interest environment—have deprived small and mid-size businesses of previously available forms of capital. This has prevented the creation of new businesses and constrained the ability of existing businesses to grow. Passage of H.R. 31, H.R. 1800, and H.R. 1973 would allow existing market trends towards BDCs to grow and fill a void that has caused serious economic harm.

Although BDCs are currently required to describe the risk factors involved in their submissions to shareholders and the Securities and Exchange Commission ("SEC"), the Chamber is concerned that investors may not fully comprehend the nature of the risks involved in BDCs. In promulgating implementing regulations, SEC should reexamine the required disclosures to insure that investors are properly aware of the risks.

b. Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act

H.R. 2274, introduced by Rep. Huizenga, would establish a notice-filing registration procedure for mergers and acquisition brokers ("M&A brokers"). This bill would permit M&A brokers, to the extent that these brokers limit their activities to transactions involving the transfer of ownership or the assets of an "eligible privately held company," to electronically register with SEC, and not be subject to all the requirements imposed on a full service broker under the Securities Exchange Act of 1934. While it would simplify the registration of these brokers, it contains a number of safeguards to prevent abuses. This bill would circumscribe the activities of an M&A broker. The bill would not exempt M&A brokers from the existing prohibitions designed to block securities law violators, criminals, and other bad actors from entering the business. It would also require disclosure of relevant information to clients and to the owner of an eligible privately held company who is offered a stock for stock transfer.

This is a common sense reform that should help entrepreneurs avail themselves of expert assistance in selling their business and realizing the full value of their enterprise, thereby providing further incentives for aspiring entrepreneurs to push forward with their ideas. By facilitating M&A activity, it would provide another source of capital for smaller companies.

c. XBRL Exemption for Small Public Companies

An efficient flow of information to investors is critical to efficient capital markets. While our securities laws are still largely rooted in a paper based system, eXtensible Business Reporting Language ("XBRL") provides machine-readable financial statements in a consistent format, making information more user-friendly for investors. Investors can quickly download information to spreadsheets without manually re-inputting the data. Investors can also search SEC filings more quickly in order to find promising investments. Clearly, digital disclosures are the way of the future and XBRL is the first step down that road.

Currently, all issuers have to furnish, but not officially "file" financial statements in XBRL, which limits issuer's liability for honest mistakes. Under the current rule 406T, scheduled to expire on October 31, 2014, issuers will not be liable for mistakes as long as the issuer makes a good faith effort to comply.

Despite the advantages of digital disclosure, the Chamber supports a temporary XBRL exemption for two reasons:

1) XBRL has been a work in progress and has undergone a number of growing pains. This system will undergo series of changes and adjustments as various stakeholders demand changes and become better acclimated with the system. It is better that small businesses not have to deal with a work in progress and instead concentrate on issues of more importance—the growth of the company. Smaller issuers should be required to use XBRL only after the bugs have been worked out and compliance costs have fallen to the point where they are less than the benefits.

2) The JOBS Act exempts small public companies from certain financial reporting obligations and other disclosure requirements. An exemption from XBRL reporting for smaller companies would be consistent with the other exemptions in the JOBS Act.

While XBRL and digital disclosures will gradually become a larger part of the information flow for capital markets, smaller public companies need not be subject to some of the hiccups. Smaller firms are less able to bear the development costs of the evolution of XBRL.

The Chamber would recommend that the discussion draft be changed to include a requirement for SEC to report to Congress on an annual basis on the progress it has made on XBRL and the use of digital disclosures to facilitate the flow of information to investors and the marketplace. The report should include estimates of the costs of compliance with the XBRL mandate and the use of XBRL by investors. This information would be useful in determining whether it would be cost effective to extend the XBRL mandate to smaller companies.

In addition, the Chamber recommends that the grace period in current SEC Rule 406T should be extended for all issuers for two years and for smaller issuers for at least five years.

The Chamber also agrees with the recent statements by SEC Chair White that there is a "disclosure overload."[1] A voluminous amount of obsolete and immaterial disclosures have effectively disenfranchised retail investors and forced investors to wade through a clutter of information at their own peril. The discussion draft could also include a requirement for SEC to periodically report to Congress on its retrospective review of obsolete and unnecessary disclosures. As an example, the Federal Communications Commission recently undertook such a retrospective review and removed over 120 regulations that were deemed to be obsolete and outdated.[2] The SEC should be able to do the same.

d. Pilot Program for Tick Size of Stocks

The move to decimalization in stock quoting and trading at the turn of the last century was a landmark moment for retail investors. Decimalization refined price discovery, tightened spreads, and lowered costs. However, trading in pennies has impacted the available liquidity in some thinly traded stocks, including many small-cap stocks. The optimal tick may not be the same for all companies, and a pilot experiment would gather useful data for examining this. Accordingly, we believe that the draft legislation proposed by Representative Duffy would help ensure that we have a market structure that supports capital formation for all public companies. This

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[1] *See* October 3, 2013 speech by Chair White entitled, ***The Importance of Independence*** and October 15, 2013 speech entitled, ***The Path Forward on Disclosure***.

[2] *See* May 17, 2013 Federal Communications Commission press release entitled FCC Lifts Unneeded Telecom Rules, Frees Millions for Investment.

legislation would permit scientific evidence-based rulemaking, which, in or opinion, is the best kind. Also, the ability to have issuers select their own tick size is reasonable.

We believe that an optional pilot program is warranted to see if such an innovation would achieve its purpose. Rulemaking should be based on solid scientific evidence, and a well-designed pilot program would gather the appropriate data for sound rulemaking. If it is successful then Congress and SEC can determine what next steps should be taken.

However, the Chamber believes that a provision should be added to provide a safe harbor to insulate management and directors from liability in exercising the option to choose a tick size. Unfortunately, we have seen all too often that some will attempt to use the courts for gain, at the expenses of investors. This is true with non-binding advisory say on pay executive compensation votes despite the intent of Congress that such actions not be subject to lawsuits. A safe harbor would recognize that directors and management are exercising their fiduciary duties in the best interest of the company and prevent resources from being dissipated at the expense of the company and investors.

Without such a safe harbor, companies may not avail themselves of the opportunity to participate in the pilot program and an opening to help smaller public companies may be lost.

e. Amend Certain Securities Laws for Treatment of Emerging Growth Companies

The Chamber supports this discussion draft, offered by Representative Fincher. One of the most important contributions of the JOBS Act was that it removed many of the practical obstacles to an IPO for Emerging Growth Companies ("EGCs"). The draft legislation would build on this. It would enable more EGCs to pursue the registration process without incurring the significant costs that can be associated with this process. It would facilitate subsequent offerings of securities to the investing public. Importantly, it would promote EGC access to the capital markets without denying investors with important real time information on which to base their investment decision.

The Chamber would also recommend that an addition to this discussion draft be included to modernize Rule 701.[3] The JOBS Act contains a provision that updated

[3] *See* June 11, 2013 letter from the Chamber to Chairman Scott Garrett and Ranking Member Carolyn Maloney of the Subcommittee on Capital Markets and Government Sponsored Enterprises

12(g) employee registration exemptions that assist privately-held companies that want to provide employees with the option of increased employee ownership. To compliment these changes to the 12(g) employee registration exemptions, SEC should update Rule 701 by raising the $5 million disclosure threshold requirements.

In 1988, SEC adopted Rule 701, which allows private companies to sell securities to employees without incurring the costs of registration for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. As a result, private companies were able to offer their employees the benefits of ownership without undertaking the costly registration process that is generally intended to protect publicly-traded securities. Under its current form, Rule 701 mandates disclosures that treat employee sales above $5 million more like capital-raising than compensation. These disclosures raise the cost of providing these securities and require private companies to risk the disclosure of confidential financial information. Moreover, this now-dated approach is one that does not account for the JOBS Act's 12(g) employee exemption or the effects of inflation.

The Rule 701 threshold should be raised and/or adjusted for inflation and updated to reflect the JOBS Act revisions. This adjustment would allow the employees working for privately-held businesses ranging from relatively new start-ups to mature companies to take full advantage of the JOBS Act 12(g) employee shareholder provisions.

III. Consequences of Inaction and Action

If these bills are not passed and if the JOBS Act is not fully implemented, economic growth and job creation will continue to underperform and stagnate for years to come.

The problem that has existed before, during and after the financial crisis is that our securities regulations reflect a pre-World War II economy at worst or the stagflation economy of the mid-1970's at best.

In other words our current regulatory apparatus for capital formation is at least two to four generations removed from the realities of today's economy and wholly unprepared for the competitive demands for the next decade.

Furthermore, this situation has been exacerbated by the unforeseen consequences of the regulatory initiatives undertaken as a result of the Dodd-Frank Act, the G-20 and the Basel Capital Accords.

Entrepreneurs may need access to credit cards and bank financing, small businesses access to debt markets, and growing businesses the ability to enter public company capital markets. Since 2008, we have seen a greater concentration of our banking system that slowly erodes the ability of smaller businesses to access capital, and the application of the Basel III capital accords upon smaller and mid-size banks has constrained the flow of resources to smaller businesses.

In effect we are prohibiting the financial sector from taking reasonable risks on the risk takers who grow our economy.

If this situation is to continue, then these bills would allow other entities to fill the void, open up our public company markets and give businesses greater flexibility to access capital. Passage of these bills would help to meet those demands and allow America to compete.

But let me also state a word of caution. While these bills are a step in the right direction, they are only a step. Because of the avalanche of regulations that are not geared to investor protection or competition and what SEC Chair White called disclosure overload, investors are increasingly turning away from the public company as a profitable investment. The bills today are geared towards increasing IPOs and early stage financing, but more should also be done to address the precipitous and relentless decline of the number of public companies in the United States. The Subcommittee's hearing on proxy advisory firms this past June is one example of rebalancing the pendulum.

The SEC must undertake a review and action to address policies and regulations that are obsolete in a 21st century economy. As we have seen with the JOBS Act and with the proposed legislation that is the subject of today's hearing, Congress sometimes has to direct SEC to take action that it may not want to do, but that it should do.

We stand ready to work with members of both parties to address these long-term issues and we believe this Subcommittee is the catalyst for such action.

IV. Conclusion

The Chamber views these bills, along with our proposed improvements, as critical steps to preserve the diverse capital structure our free enterprise system needs and to allow for the dynamic changes the market place demands in order to provide the life blood necessary for entrepreneurs to start a business and for small and mid-size businesses to grow into larger ones. This has been the formula for success that

has allowed the United States economy to grow at unprecedented levels throughout its history. More importantly, these bills, along with the full implementation of the JOBS Act are necessary for American businesses to succeed in an ever increasing competitive global economy.

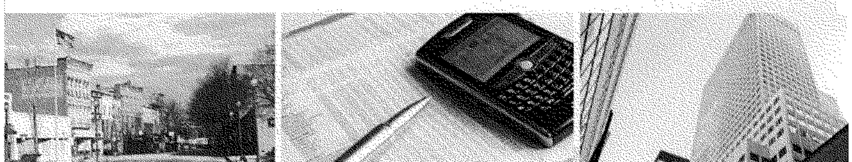
I am happy to take any questions that you may have at this time.

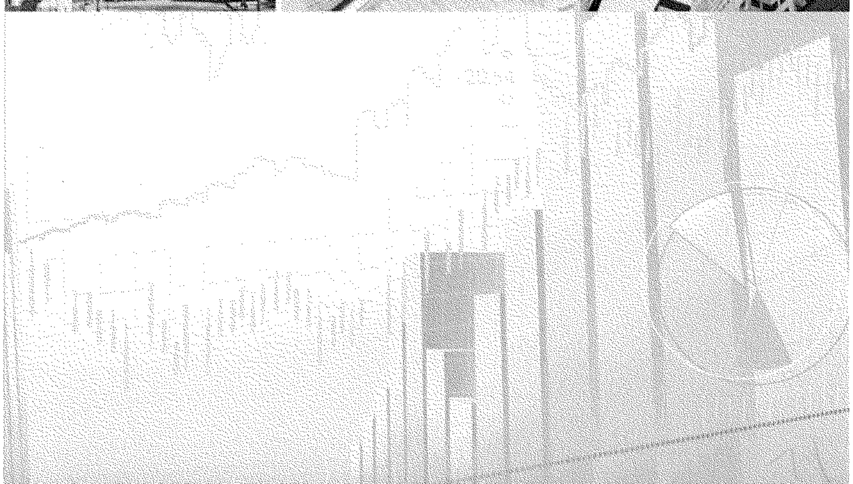
Center for Capital Markets
Competitiveness

SOURCES OF CAPITAL AND ECONOMIC GROWTH:

Interconnected and Diverse Markets Driving U.S. Competitiveness

Spring 2011





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CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.

Contents

Executive Summary

This paper provides a broad overview of the U.S. financial system. It describes the variety of financing sources available to both individual consumers and businesses, and the considerations that lead a consumer or a business to choose a specific financing source. It then discusses how this variety of financing sources provides benefits to the economy. Five main conclusions emerge from this analysis.

First, a robust, efficient, and diverse financial system facilitates economic growth. Research has shown that the level of financial development is a strong predictor of economic growth. This research is based on a study of a large number of countries. Even with the unprecedented economic crisis, the growth in the U.S. financial services industry has been accompanied by a robust growth in our economy, as measured by growth in gross domestic product (GDP). The financial system facilitates economic growth by providing four basic services:

- facilitating trade;
- facilitating risk management for various individuals and businesses;
- mobilizing resources; and
- obtaining information, evaluating businesses and individuals based on this information, and allocating capital.

It is through the provision of these services that the financial system ensures that investment capital is channeled most efficiently from the providers of capital to the users of capital, so that both the economy and employment grow.

Second, in terms of their financing choices, individuals are largely limited to debt financing for raising capital. For individuals, these sources include family and friends, credit cards, home equity loans, and other types of bank loans. Consumer credit provided through these diverse sources is a large segment of our economy. The major providers of consumer credit—commercial banks, finance companies, credit unions, the federal government, savings institutions, and nonfinancial businesses—provided over $2.4 trillion of consumer credit as of year-end 2010. The efficient availability of this credit is critical in an economy so dependent on domestic consumption. It is important to note that for many smaller businesses, especially start-ups, these consumer credit products are often the only available sources of new or even working capital. Entrepreneurs often rely on access to personal credit, including credit cards and home equity loans, to launch their new businesses.

Third, as businesses grow they can access both debt and equity financing, and the mix of these two, called the "capital structure" decision, is an important choice every business makes. Three broad categories of financing sources are available to businesses for either debt or equity capital. One source of capital involves raising funds without using any intermediaries like banks or going to the public capital market. Included in this category are family and friends, employee ownership, retained earnings generated by the operating profits of the business, customers and suppliers, and angel investors. A second category is intermediated finance that does not involve going to the capital market. Included in this are loans from intermediaries like banks and insurance companies, funding by private-equity firms and venture capitalists, small business investment companies that provide Small-Business-Administration-sponsored financing, and

factoring companies that provide financing against receivables. While all these financing sources are important, venture capital has played an especially vital role in helping launch new businesses: venture capital financing accounts for 21% of GDP. Many famous companies like Apple were financed in their infancy by venture capital. For more mature business, bank loans are an essential source of finance. In 2009, U.S. banks made more than $7 trillion in loans. The third category of financing available to businesses is direct capital market access, whereby the firm uses an investment bank and sells debt or equity claims directly to capital-market investors. These include commercial paper, initial public offerings (IPOs), bond sales, and secondary equity offerings.

Fourth, a rich diversity of financing sources is provided by the U.S. financial system. This diversity helps U.S. consumers and businesses to better manage their risks and lowers their cost of capital. Diversity enables consumers and businesses to effectively match their financing needs to the financing sources, with each financing source providing a different set of services. Since the needs of those seeking financing differ, it is beneficial to have specialized financiers catering to different needs. The result is better risk management and higher investment in the economy, leading to an increase in GDP and employment.

Fifth, the U.S. financial system is highly interconnected. What happens to one financing source typically affects a host of other financing sources as well as those seeking financing. These spillover effects cause any change in the part of the system to be propagated through the entire system, often in ways that are difficult to predict. For example, if our public equity markets were to diminish in the future—say due to excessively onerous regulation—it is very likely that the supply of private equity and venture capital financing would decline as well. Hence, assessing the risks associated with regulatory changes in the financial system is a notoriously difficult task. This often leads to unintended consequences when changes are introduced in some part of the financial system. Disturbing examples of this can be found in the impact of the Sarbanes-Oxley Act and the litigation environment faced by U.S. companies. These changes have contributed to a slowdown of the rate at which new public companies are formed and an increase in the rate at which existing public companies are leaving the market, leading to a substantial decline in the number of publicly listed U.S. companies.

A well-developed financial system goes hand-in-hand with robust economic growth and increased employment.

A well-developed financial system goes hand-in-hand with robust economic growth and increased employment. The better the financial system functions, the more new companies are launched, the larger the number of publicly listed companies, the better the overall management of risk, the greater the availability of consumer credit, and the higher aggregate investment.

I. Introduction

In the early 1980s, the financial services industry accounted for about 10% of total corporate profits in the United States. In 2007, it was 40%. Some have used statistics like this to argue that financial services are becoming excessively important at the expense of other parts of the economy, such as manufacturing and services that produce obviously tangible economic value. However, nothing could be further from the truth. Given the economic crisis we have witnessed over the past three years, it is easy to forget that growth in financial services over the past two decades was also accompanied by some of the most spectacular economic growth we have ever witnessed. In the 1980s, U.S. gross domestic product (GDP), the most commonly used measure of the size of the economy, stood at under $3 trillion. In 2007, when the share of total corporate profits accounted for by financial services was four times as large as in the 1980s, it was around $14 trillion. Today the U.S. financial services industry employs more than 5.77 million people, about 6% of total private non-farm employment, and this number is projected to grow to 12% by 2018. The wealth generated by the financial services industry contributed nearly 6% ($828 billion) to U.S. GDP in 2009.[1]

In the wake of the recent financial crisis, some have argued that the economic growth we witnessed was merely an unsustainable bubble, and that when the bubble burst, the economy came crashing down. While the causes of this crisis are not the topic of this paper, it is worth noting that the crisis was a consequence of a *variety* of factors in the United States: an excess supply of liquidity due to a global liquidity-imbalance, an easy-money monetary policy, a political desire for widespread home ownership, and various developments in the financial sector. All of these factors need attention if we are to have a well-regulated, transparent, efficient, and robust financial system consisting of a diversity of financing sources. Thus, financial reform must go hand in hand with a strong financial services sector. The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act tackles a variety of financial reform issues, but many of the specific regulations have yet to be written, so time will tell about how effectively the Act will deal with the causes of the crisis. Nonetheless, an important point to remember is that the data show a strong correlation between economic growth and strength of financial services.

Financial markets and the financial service firms that operate in those markets help individuals and businesses raise capital of various sorts, as they channel money from savers to those with investment ideas.

It was not a coincidence that the U.S. economy grew so rapidly during a time that financial services grew in importance. Financial markets and the financial service firms that operate in those markets help individuals and businesses raise capital of various sorts, as they channel money from savers to those with investment ideas. The more well developed the financial system, the better lubricated this channel, and the lower the transactions costs and other impediments to investment and economic growth.

1 U.S. Financial Services Industry: Contributing to a More Competitive U.S. Economy, SIFMA, http://www.ita.doc.gov/td/finance/publications/U.S.%20Financial%20Services%20Industry.pdf, (July 2010).

Indeed, one of the roadblocks to economic growth in the former eastern-block Communist countries in Europe, such as Romania, has been the lack of developed financial systems. The fact that the U.S financial system is well developed and innovative has been a big boon to individuals and businesses, as they have been able to access a variety of financing sources to raise relatively low-cost capital to grow. Even within the United States, the number one reason for the failure of small businesses is lack of access to funding. Put differently, when small businesses do succeed and create employment and growth, an important factor in their success is access to the financing needed to support growth. The strength of the financial system has also been a significant factor in the creation of prominent new firms that have been launched in the past 25 years and have gone on to become global powerhouses. Starbucks, Yahoo, Google, and eBay are but a few examples. No other country in the world can match this, in large part because no other country in the world has such a deep and vibrant financial system.

When small businesses do succeed and create employment and growth, an important factor in their success is access to the financing needed to support growth.

What is the U.S. financial system composed of and how does it work? What makes it so deep and vibrant? These are the main questions addressed in this research paper. Section II discusses the role of the financial system in promoting economic growth. Section III provides an overview of the financial system and addresses the question of how the financial system functions. The focus is on the types of businesses that are involved in raising capital, the types of financing sources available to them, and the financial instruments/contracts that are used to raise capital. Section IV discusses how different parts of the financial system are connected and the role of the large diversity of financing sources in making the financial system deep and vibrant, and facilitating economic growth.

II. The Role of the Financial System in Promoting Economic Growth

There is a rich body of research on the role of the financial system in promoting economic growth, much of it from comparisons of different countries. For example, in a study of 56 developing countries, the level of financial development in 1960 was a strong predictor of economic growth over the next 30 years, after controlling for a variety of economic and political factors.[2] This and other studies provide ample evidence that robust financial development is followed by healthy economic growth. This section will discuss this research to develop an understanding of what the facts say and *why* they say what they say. But first, it is useful to understand the basic economics behind *how* the financial system promotes economic growth.

The Conceptual Link Between the Financial System and Economic Growth

A simple example illustrates this link. Suppose we have a community in which four people own productive resources: Mary, Peter, Paul, and Sally. Mary has saved some money that she keeps in a safe in her house. Peter owns an orchard and some apple seeds that he can plant to grow trees and harvest apples. Paul has a farm on which he naturally produces fertilizer. Sally owns some farm equipment that can be used for tilling the land and digging holes for planting trees.

Neither Paul nor Sally is willing to sell any goods or services for the promise of a future return. They will sell only if they get paid now. But Peter has no money to pay anyone now. Mary, on the other hand, is patient and would not mind giving her money to someone now in exchange for a larger payment in the future. However, she does not know Peter well and is concerned that he might be a crook who will simply abscond with her money if she lends it to him.

Without a financial system in this community, Peter will be limited to planting whatever apple trees he can using his own seeds and labor, but without any fertilizer or farm equipment. Suppose he can plant a few trees and harvest 500 apples a year. That then defines his economic output.

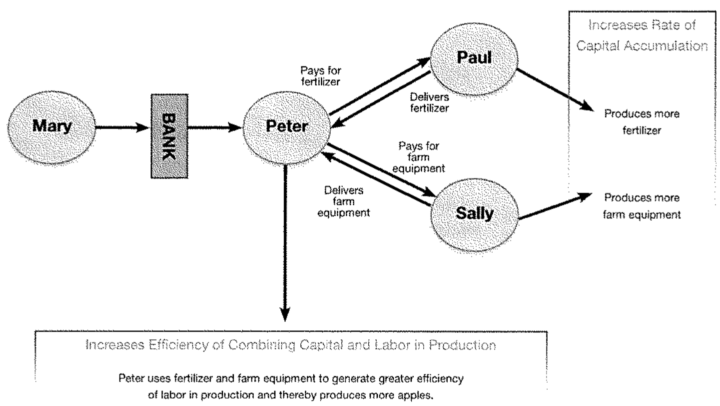
Now suppose the community's financial system includes a bank and a financial market where financial securities are traded. Now Peter can go to the bank and request a loan that would be repaid from future sales of apples. The bank will conduct a credit analysis and determine whether Peter is a good credit risk. The bank will also monitor Peter to make sure that he is not a crook who absconds with the bank loan. With the assurances provided, Mary will be willing to deposit her money in the bank. This is better for her than keeping the money idle in a safe in her house and earning zero interest. With the bank loan, Peter will buy some fertilizer from Paul and some farm equipment from Sally on a cash-on-purchase basis. He can now plant more trees to produce more apples, so he ends up with 10,000 apples rather than 500. The economic output of this economy has gone up due to the financial market. A further increase in economic output may arise from the fact that Paul and Sally may use the money Peter pays them to produce more fertilizer and farm equipment. This output may have uses in other parts of the economy, leading to further increases in economic output, and so on (see figure 1).

2 See Levine (1996).

This simple example illustrates three important ways in which the financial system contributes to economic growth:

- it increases trade and the flow of goods and services;
- it increases the rate of physical capital accumulation; and
- it increases the efficiency of combining capital and labor in production.

***Figure 1*: How the Financial System Promotes Growth**



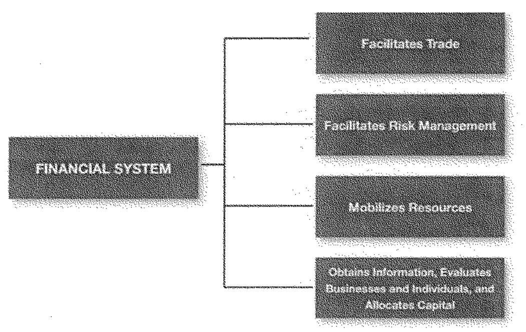
The Services the Financial System Provides and How They Help Economic Growth

There are four basic services provided by financial systems that help spur economic growth[3] (see figure 2).

The Financial System Facilitates Trade: In primitive economies, trade was based on barter, something that Peter and Paul could not do in our example because Peter had no apples in his inventory to trade. The invention of money minimized the need for barter trade, thereby increasing commercial transactions and trade. In modern economies, it is not enough to have money to facilitate transactions—this money needs to be moved around. Financial systems, with the appropriate hubs and spokes for recording and clearing multilateral financial transactions, help to move money from one party to the other and often across national boundaries. Without these systems, companies would be greatly impeded in their ability to do business with each other, and economic growth would suffer.

The Financial System Facilitates Risk Management: Financial systems help individuals and businesses improve their management of various sorts of risks. This is important for economic growth because increased risk reduces investment. In our example, Peter faces some risk when he buys fertilizer and farm equipment to increase his apple crop. If it does not rain as much as Peter expects, he may have a lean harvest and be unable to fully repay his bank loan. This may cause him to lose his farm to the bank. Or there may be enough rain, but new apple orchards may spring up in neighboring communities and the market may be flooded with apples, pushing the price of apples well below normal. These risks may cause Peter to cut back on how much

Figure 2: **The Basic Services Provided by a Financial System**



3 See Levine (1996).

he invests in buying fertilizer and farm equipment. A financial system *prices* risk and provides mechanisms for pooling, ameliorating, and trading risk. It provides producers like Peter a way to manage risks. For example, Peter could use the financial system to purchase insurance against a low harvest or could hedge apple price risk in the futures market. The financial system also gives investors like Mary better risk management opportunities. For example, Mary may be concerned about *liquidity risk* if she lends directly to Peter. Once the money is loaned, Mary may be unable to get any of it back until the apples are harvested and sold. But what if a medical emergency arises and Mary needs the money before then? With a financial system, Mary would simply withdraw her deposit from the bank when she needs it. Thus, *a financial system, by facilitating improved risk management for both borrowers and savers, spurs long-run investments that fuel economic growth.*

A financial system, by facilitating improved risk management for both borrowers and savers, spurs long-run investments that fuel economic growth.

The Financial System Mobilizes Resources: As our example shows, without a financial system, Mary's savings would have stayed locked up in her safe. It took a financial system to mobilize those resources and get them to Peter, who could put them to productive use. Almost 150 years ago, the famous economist Walter Bagehot described how the financial system helps to mobilizes resources and spur economic growth:[4]

> "We have entirely lost the idea that any undertaking likely to pay, and seen to be likely, can perish for want of money; yet no idea was more familiar to our ancestors, or is more common in most counties. A citizen of Long in Queen Elizabeth's time...would have thought that it was no use inventing railways (if he could have understood what a railway meant), for you would not have been able to collect the capital with which to make them. At this moment, in colonies and in all rude countries, there is no large sum of transferable money, there is not fund from which you can borrow, and out of which you can make immense works."

What Bagehot was referring to was the ability of the financial system to mobilize resources that would permit the development of better technologies that lead to economic growth.

The Financial System Obtains and Processes Information and Allocates Capital: Individual savers, like Mary, may not have the resources or expertise to evaluate firms, projects, and managers before deciding whether to invest in them. Financial intermediaries, like banks and investment banks, have a cost and expertise advantage in collecting and processing such information, and then helping the capital-allocation process based on that information.[5] This, in turn, encourages investors to supply capital to these intermediaries, which channel the capital to businesses that make investments that fuel economic growth.

For example, imagine that someone comes to you and asks for a loan to finance a new restaurant. While you have the money to lend, you are not sure this is a good investment for you. But if your friend goes to a bank for the loan, the bank can gather the

4 See Bagehot (1873), reprinted 1962, as noted by Levine (1996).

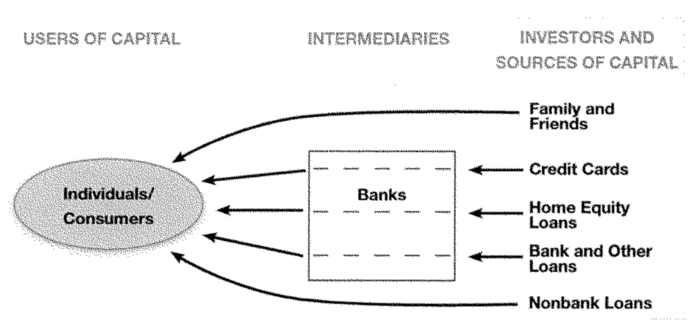
5 See Greenbaum and Thakor (2007).

necessary information about potential future income and the assets purchased with the loan that can be used as collateral, conduct the necessary credit analysis with this information, and decide whether to lend and how to structure the loan. Such expertise is part of the bank's business skill set. Knowing that the bank will do this, you may be willing to deposit your money so that the bank can, in turn, use it to make loans.

In a different context, venture capitalists are also information-processing experts. When a venture capital firm like Sequoia Capital evaluates a start-up firm, it uses its expertise in assessing the firm's growth potential and odds of success on the basis of the firm's business plan. It then uses this assessment to decide whether to provide financing. Promising new ventures that survive this screening are able to obtain more financing than they might receive from family and friends.

In summary, the financial system provides four key services—facilitates trade, facilitates risk management, mobilizes resources, and acquires and processes information that helps in the allocation of capital. These key services help to increase the flow of goods and services, increase the rate of physical capital accumulation, and increase the efficiency of combining capital and labor in production. The result is more economic growth.

***Figure 3*: The U.S. Financial System: Individuals/Consumers**



III. An Overview of How the U.S. Financial System Works

The U.S. financial system is a complex mosaic of institutions, markets, investors (businesses and individuals), savers, and financial contracts, all of which are interconnected. Before we can understand the role played by each part of the financial system, it is necessary to understand some key distinctions between the contracts by which financial capital is raised and the differences between individuals/consumers and businesses with respect to how these financing contracts are used.

***Figure 4*: The U.S. Financial System: Businesses Raising Equity Financing**

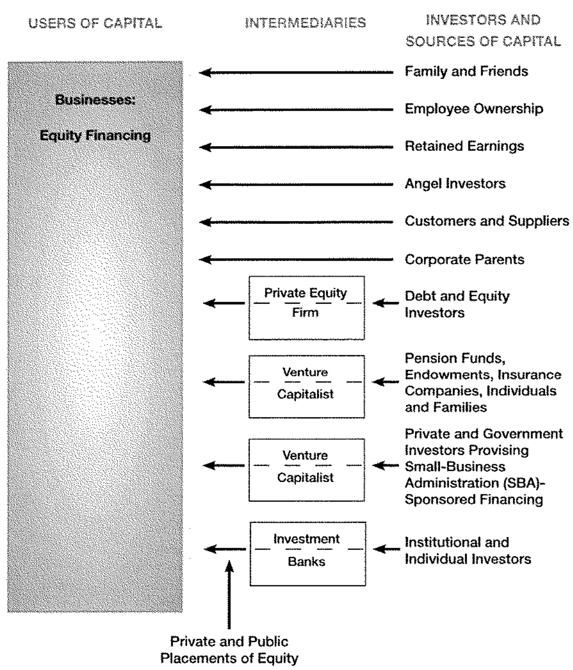
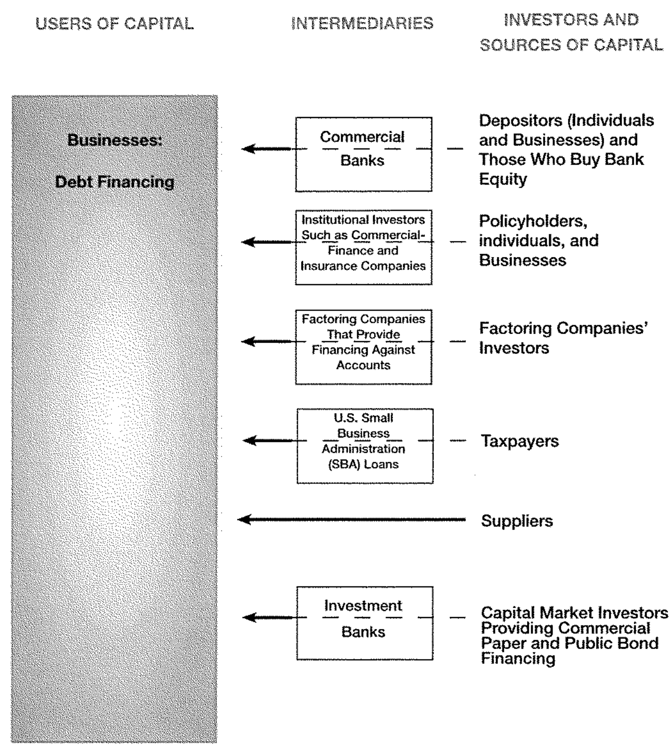


Figure 5: The U.S. Financial System: Businesses Raising Debt Financing



Debt Versus Equity and Use by Consumers and Businesses

Although a highly developed financial system like the United States has a plethora of financial contracts, the contracts by which individuals and businesses raise capital can be divided into two main groups: equity and debt.

With an equity contract, a business wishing to raise capital would sell an ownership stake in the business to investors, who would provide the external financing the business needs. In the example discussed earlier, Peter might go to Mary and offer her a 30% ownership share in his apple business in order to raise the money to buy fertilizer and farm equipment, rather than taking a bank loan. How much money Mary would make on her investment would depend entirely on the profitability of the business. If Mary invested $100,000 for a 30% ownership share and Peter made a profit of $15,000 in the first year after paying off all his operating expenses, Mary would be entitled to receive 30% of that, which is $4,500. If Peter's business made a profit of $50,000, Mary would get $15,000 in the first year alone, and if the business made no profit in the first year, Mary would get nothing in the first year. Each year, Mary would receive 30% of the profits, assuming all profit is distributed as dividends. Moreover, Mary's investment has no stated maturity. That means Peter never has to return her original investment of $100,000 to her as a lump sum. The only way for Mary to recover that original investment is to sell her ownership stake to someone else.

With a debt contract—for example, a bank loan—the lender is promised a repayment of the original loan amount plus some interest. A debt claim has both a *stated maturity* and *priority over equity*. "Stated maturity" means that the lender must be fully repaid by a certain date. "Priority over equity" means that debt holders must be fully repaid before shareholders can be paid. In our example, if Peter finances with a bank loan, he must first use all of the profit from selling apples to repay the bank, even before he pays taxes. Only after he repays the bank and pays his taxes can he keep what is left over for himself as the owner of his business.

Consumers finance primarily with debt contracts.

Consumers finance primarily with debt contracts. Bank loans, home mortgages, and credit card borrowing are all forms of debt contracts. There is a good reason why equity is not used in consumer financing. A loan taken by a consumer is essentially a financial claim by the lender on the borrower's future labor income. It is relatively easy for the borrower to simply withhold the supply of this labor income—for example, by quitting work—and make the lender's claim worthless. A debt contract, with a requirement to repay by a certain date and penalties for not repaying, provides better incentives for the borrower to repay.

Businesses finance with both debt and equity. In fact, the mix of debt and equity financing is an important decision for any business. Equity financing is viable for businesses because the financial system provides corporate governance to keep managerial actions roughly aligned with the interests of the financiers of the business. Further, businesses have powerful incentives to keep producing profits,

Businesses finance with both debt and equity. In fact, the mix of debt and equity financing is an important decision for any business.

so they are unlikely to withhold the supply of productive inputs like labor.

Individual/Consumer Financing

Consumers can tap a variety of sources for financing, most of which is in the form of debt (see figure 3).

Friends and family provide a potentially significant source of capital. Often these loans have vaguely defined maturity with specific purposes, for example, a student loan that will be repaid sometime after graduation or a car loan. Many people rely on this form of financing in emergencies or for purposes for which bank loans are difficult to get.

Credit card financing is unsecured debt, which means there is no specific collateral backing the loan. Since it is largely used as a means of transaction financing, the issuer expects to be repaid from the borrower's income within a relatively short time. Interest rates and late-payment fees tend to be high to encourage prompt payment. The viability of credit card financing rests on a well-developed financial system with a high level of trust and a deep financial market in which banks can raise financing by securitizing their credit card receivables and selling the claims to investors. The volume of credit card finance, and hence the enormous payment-transactions convenience afforded to consumers, both decline exponentially as one moves from well-developed financial systems (like the United States) to less-developed financial systems.

Home equity loans are a convenient way for consumers to borrow against the price appreciation in their homes. For example, say you need $75,000. Your home is worth $300,000 and you owe the bank $200,000. Then your home equity is $100,000 ($300,000 minus $200,000), and you can borrow the $75,000 you need against the home equity. Of course, once you take the loan, you will be faced with additional monthly payments on the loan.

Before the subprime financial crisis, home equity loans were a significant source of finance for many consumers. The average U.S. homeowner extracted 25–30 cents for every dollar increase in home equity during 2002–2006, and home-equity-based borrowing was equal to 2.8% of GDP every year from 2002 to 2006.[6]

Bank and other loans represent a significant portion of the financing available to individuals. These loans include borrowing from commercial banks, finance companies (e.g., car loans), credit unions, the federal government, and so on. The amount of this borrowing is huge. As of year-end 2010, consumer credit outstanding was $2.41 trillion, having grown at an annual rate of 2.5% in the fourth quarter of 2010 (see table 1).

Nonbank loans are provided by a wide array of lenders. Perhaps the biggest nonbank financial intermediary is the U.S. government. From Fannie Mae and Freddie Mac to Sally Mae (the Student Loan Marketing Association), the amount of credit provision that involves the U.S. government dwarfs that by any bank.

Various other lenders also exist on the "periphery" of the financial services industry and serve as "bankers" to the poor and the excluded. *Pawnbrokers* are one such group of lenders. Pawnbroking is a form of asset-backed (secured) lending. The lender makes a loan that typically is small, say $50-$100, for a few weeks or months, and is secured with merchandise (e.g., jewelry, electronics) that has a resale value roughly twice the debt. Interest rates tend to be high, roughly 25–30% per month in some states. Default rates range between 10%

6 See Mian and Sufi (2010).

Table 1: **Consumer Credit Outstanding**

Major Providers of Consumer Credit	Consumer Credit in $ Billions by Year				
	2006	2007	2008	2009	2010
Commercial banks, finance companies, credit unions, federal government, savings institutions, and nonfinancial business	$2,384.80	$2,522.20	$2,561.10	$2,449.90	$2,410.40

Source: Federal Reserve Statistical Release, February 7, 2011.

and 30%. In 2004, there were 15,000 pawnbrokers in the United States.[7]

Payday lenders represent another source of nonbank credit. They provide unsecured, short-term loans to customers. The loan arises in one of two ways. The first is a "traditional" payday loan, in which the borrower writes a post-dated (or undated) personal check to the lender, and the lender makes a loan equal to the check amount minus a finance charge. The lender usually deposits the check and gets paid the day the borrower receives his pay. The second involves the lender directly debiting the borrower's bank checking account on a future date for the amount of the loan plus the finance charge. The typical loan has a two-week maturity. Payday lending is legal and regulated in many states, but is illegal or infeasible given the law in some states.

Title lenders are similar to payday lenders, the difference being that title lenders make secured loans rather than unsecured loans. That is, the title holder (lender) holds collateral against the loan. Car title loans are quite common, and in this case the lender holds the title to the borrower's car until the loan is repaid. Title lending is an extension of pawnbroking. A key difference is that while a pawnbroker keeps possession of the collateral during the term of the loan, the title lender may permit the collateral to remain with the borrower while the loan is outstanding and repossess it only upon default.

Attention will be turned next to business financing. While for purposes of discussion, it is useful to create a clean separation between consumer and business financing, in practice this dividing line is often fuzzy. In particular, many individuals will use their access to consumer financing to raise the money they need to invest in their businesses. For example, someone may charge a business purchase to a personal credit card or use a home equity loan to make the investment needed to expand the business.

Business Financing: Equity

Businesses can raise equity financing from a richly diverse set of sources (see figure 4).

Internal Equity Financing

Family and friends represent an important financing source for start-up businesses. The typical family or friend investor is someone who has been successful in his own business and wishes to invest both to help a family member or friend and/or because someone had made a similar investment in his business when it was a start-up. For example, a health care private equity firm was launched about 10 years ago in St. Louis, MO, with financing provided entirely by family and friends because the founders discovered that no Wall Street firm was willing to

7 See Greenbaum and Thakor (2007).

provide start-up financing to a group of individuals who had operating experience in the industry but no private-equity experience. Similarly, Facebook was launched from a Harvard dorm room and eventually expanded with family and friends financing. Typically, family and friends will invest up to $100,000 each.

Employee ownership is another way in which firms can raise equity financing. Employee stock ownership plans (ESOPs) give employees the opportunity to become shareholders in the company. As shareholders, employees can experience increased pride and security, and may become more productive. Employees can participate via stock purchases, by receiving a portion of their compensation as stock rather than cash, and sometimes by providing personal assets to the business. There are more than 11,500 ESOPs in place in the United States, covering 10 million employees (10% of the private-sector workforce). The total assets owned by U.S. ESOPs were estimated at $901 billion at end of 2007.[8]

Retained earnings represent a vital source of internal equity financing for businesses. When a firm makes a profit at the end of a year after settling all its expenses, paying creditors, and paying taxes, it will typically pay out a portion of the profits as a dividend to its shareholders. The amount remaining after the dividend payment is called *retained earnings*, and it augments the firm's equity. Retained earnings may be viewed as a "sacrifice" made by the shareholders in the sense that they forgo some dividends in order to build up the firm's equity. Companies generally retain 30% to 80% of their after-tax profit every year.

External Equity Financing

Angel financing involves raising equity capital from individual investors, known as "angels." These individuals look for companies that have high growth prospects and some synergies with their own businesses, and operate in an industry that the individuals have successfully worked in or are bullish about. Angel financing is quite often tapped by early-stage companies that have yet to establish a track record of revenues or earnings that would enable them to obtain institutional financing from venture capital firms or banks. In our apple-orchard example, if Peter cannot get a bank loan to buy fertilizer and farm equipment, he might seek out angel investors (typically investors who, unlike Mary, know him and something about his business) to provide the financing in exchange for an (equity) ownership stake in the business.

Angel financing is quite often tapped by early-stage companies that have yet to establish a track record of revenues or earnings that would enable them to obtain institutional financing from venture capital firms or banks.

Angel financing is often quite expensive. Capital from angel investors can cost the entrepreneur anywhere from 10% to 50% of the ownership in the business. In addition, many angel investors charge a monthly management fee.

Businesses can sometimes raise equity financing from ***customers, suppliers, and sales representatives***. These parties may be motivated to provide financing because they believe that the business has growth potential that may not be realized without the financial support provided by the equity input, and also that the equity position may become a profitable investment down the road. For example,

8 The ESOP Association Industry Statistics, http://www.esopassociation.org/media/media_statistics.asp (March 2011).

IBM once invested enough in Intel to own 20% of Intel's equity. It made this investment to financially boost Intel, a key supplier whose microprocessors were used in all IBM personal computers.

Corporate parents represent another significant financing source for some institutions. A holding company may provide its subsidiary with capital rather than incurring the cost of raising external capital. For example, when ABN-Amro, the Dutch banking giant, acquired LaSalle Bank in Chicago in 1979, it infused $300 million of capital into its newly acquired subsidiary.

Intermediated Equity Capital

Thus far we have discussed non intermediated sources of equity capital, in which the user obtains capital directly from the investors (who represent the sources of capital). Other forms of equity capital involve financial intermediaries that help to link the sources and users of capital.

The first of these is ***private equity***. The term private equity (PE) is used to refer to a firm whose equity is not publicly traded on a stock exchange or capital that is not quoted on a public exchange. PE firms specialize in buying firms, some of which may be publicly owned, and holding them as part of a portfolio of privately-owned firms. After they improve the management of these firms, the PE firms either sell them to other firms or take them public through a sale of stock in the market. For example, the Blackstone Group's PE unit recently acquired theme park operator Busch Entertainment Corp. (previously owned by the Anheuser-Busch Corp.) and renamed it SeaWorld Parks & Entertainment. Blackstone also acquired frozen-foods maker Birds Eye Foods in a PE transaction.

PE firms are typically organized as limited partnerships to hold investments in which investment professionals serve as general partners, and investors serve as passive limited partners and provide the capital. The PE firm usually collects a management fee of 2% or less plus 20% of the capital gain from the investment. Many PE firms deliver attractive returns to their investors, net of these charges.

PE firms specialize in buying firms, some of which may be publicly owned, and holding them as part of a portfolio of privately-owned firms.

The largest PE firm in the world is Kohlberg Kravis Roberts & Co. (KKR), which had more than $230 billion in completed and pending acquisitions during 2005–2010. Other big PE firms include the Blackstone Group LP, Carlyle Group, Cerberus, Clayton Dubilier and Rice, Goldman Sachs Capital Partners, Bain Capital, TPG Capital, and Permira. While these are the largest PE firms, they represent a mere fraction of the total number of PE firms in the business. There are more than 2,500 PE firms worldwide, and they raise many billions of dollars in capital every year. In 2006, PE firms bought 654 U.S. companies for $375 billion, and U.S.-based PE firms raised $215.4 billion in investor commitments.[9]

PE firms use a variety of strategies to acquire firms: leveraged buyouts (LBO), growth capital, distressed investments, mezzanine capital, and venture capital. In a typical LBO deal, the PE firm acquires majority control of an existing or mature firm and finances the acquisition with a relatively high amount of debt. The assets of the acquired firm serve as collateral for the debt used by the PE firms to acquire it.

9 Robert J. Samuelson, The Private Equity Boom, Washington Post, http://www.washingtonpost.com/wp-dyn/content/article/2007/03/14/AR2007031402177.html (March 17, 2007).

Over time, the cash flows generated by the acquired firm help to pay off the debt used for the acquisition.

Venture capital will be discussed shortly as a distinct source of equity capital because there are also specialized venture capitalists that do not do private equity deals. Growth capital refers to equity investments, quite frequently minority investments, made by PE firms in mature companies that are seeking capital to expand or restructure operations or fund some other major investment. By obtaining this capital from a PE firm, the firm that acquires the capital avoids the dilution in the capital market that would occur if it were to issue equity. There is ownership dilution with a PE firm as well, but the minority ownership of the PE firm represents a (monolithic) block ownership as opposed to a more diffused dilution in the capital market.

Distressed investments are investments (either debt or equity) that PE firms undertake in financially distressed companies. Occasionally, PE firms will take more senior positions than equity in either distressed or healthy firms. These may be subordinated debt or preferred stock (which has seniority over common equity but is junior to debt). The objective in taking such positions would be to reduce the PE firm's risk exposure.

Mezzanine capital refers to a subordinated debt or preferred equity claim on the firm's assets that is senior to the firm's common equity, but junior to other claims. Such capital has a lower return but less risk for the PE firm providing the financing.

Venture capital (VC) is an enormously important source of finance for start-up companies. The fact that the United States has the most well-developed VC market in the world—with Silicon Valley setting the "gold standard" for a VC community—has often been singled out as a key reason for the successful launch of so many new companies in the United States. Numerous famous firms, such as Apple, Google, and Microsoft, were launched with the help of VC financing.

VC-backed companies account for 21% of U.S. GDP and thus play a vital role in job creation in our knowledge economy. Two million new businesses are created every year in the United States, of which about 600 to 800 get VC funding.[10]

VC financing is provided by both government-sponsored and private entities. In fact, an initial step in the development of this industry was the passage of the *Small Business Investment Act of 1958*, which allowed the SBA to license private "Small Business Investment Companies" (SBICs) to help fill the gap between the availability of VC and the needs of small businesses in start-up and growth situations. The structure of the program is unique in that SBICs are privately owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed at favorable rates with an SBA guarantee to make equity and debt investments in qualifying small businesses.

There is also a substantial institutional VC industry in the United States. These privately owned financial intermediaries typically invest in high-growth companies that are capable of reaching sales of at least $25 million in five years. According to recent estimates based on surveys from the National Venture Capital Association, U.S. venture capital firms invest between $5 billion and $10 billion per year. Since 1970, VC firms have reportedly invested in more than 27,000 start-ups to the tune of $456 billion. Some of the major VC firms include Sequoia Capital, Benchmark Capital, Mitsubishi UFJ Capital, and Kleiner, Perkins, Caufield & Byers.

10 *Venture Impact: The Economic Importance of Venture Backed Companies to the U.S. Economy*, (National Venture Capital Association) (2009).

VC firms raise their own financing from investors (sources of capital). These include pension funds (42% of funds), insurance companies (25% of funds), endowments (21% of funds), individuals and families (10% of funds), and others (2% of funds). VC firms typically stay invested in their portfolio companies for five to eight years before selling them off.

Investment banks also act as intermediaries that help businesses raise capital from a variety of sources. An investment bank is a financial institution that assists individuals, corporations, and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also help companies involved in mergers and acquisitions by providing a host of services, such as market making, trading of derivatives, bonds, equity, foreign exchange, and commodities.

Unlike commercial banks, investment banks do not finance themselves with deposits, although most major Wall Street investment banks have become parts of Bank Holding Companies since the subprime financial crisis. Investment banks may have VC subsidiaries that provide VC financing to businesses.

Investment banks also help businesses with ***private placements of equity***, whereby new equity capital can be raised without having to issue equity on the public stock exchanges. A firm that wishes to raise equity hires an investment bank to locate institutional and individual investors who wish to invest in the company. These investors purchase the equity being offered for sale in privately arranged transactions. For a private firm, the benefit of this is obvious—because it is not publicly listed, a private placement allows it to raise equity capital beyond what is available from retained earnings. The additional capital can help to finance expansion, business growth, and additional employment. But sometimes even public firms take advantage of private placement, because it helps to raise equity capital without additional information disclosure of the kind required for a public offering. This can be beneficial for firms that wish to protect the confidentiality of product information or technology.

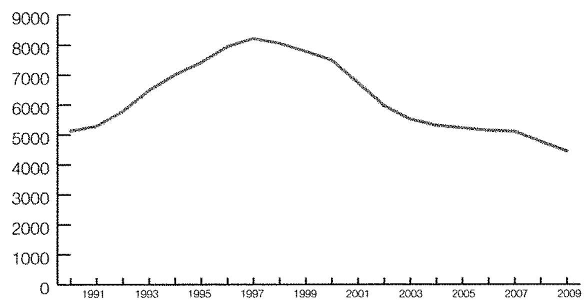
Facebook is a good example of how private placement of equity can help a firm raise financing for growth. A relatively new company that is at the vanguard of the social-network phenomenon, Facebook's initial equity funding came from private-equity placements with Peter Theil (co-founder of PayPal), Accel Partners, and Greylock Partners. The first round of private-equity investment in Facebook came in September 2004 when Peter Thiel invested $500,000 (valuing the company at $5 million). Since then, PE firms have continued to invest in Facebook. In early 2011, a fund organized by Goldman Sachs invested more than $1 billion in Facebook. General Atlantic recently agreed to purchase 0.1% of Facebook from its employees at a price that values Facebook at $65 billion.

In terms of public offerings of equity, investment banks help to take private firms public through ***initial public offerings (IPOs)*** of stock. An IPO involves the sale of common stock to the public for the first time. Through the IPO, part of the ownership of the company transfers from the entrepreneur(s) who launched the company to capital-market investors. In exchange, the firm is able to raise hard cash as it sells its shares to investors. The firm will typically hire an investment bank to help with the IPO. Among the many services the investment bank provides are the pricing of the IPO, the "road shows" during which the company is publicized to potential investors prior to the IPO, and the actual underwriting of the equity issue. The investment bank receives a percentage of the proceeds of the IPO as compensation for its services.

A number of large IPOs have been in the news. AT&T Wireless did a $10.6 billion IPO in 2000, and in 2010 General Motors re-emerged from post bankruptcy privatization with a $23.1 billion IPO. We all remember Google's IPO in 2004, which turned its 1,000 employees (who were shareholders) into instant millionaires, and its founders, Sergey Brin and Larry Page, into billionaires. Moreover, with its publicly traded stock from the IPO serving as currency, Google was able to acquire video-sharing service YouTube in 2006 for $1.6 billion.

Apart from a short rebound of a couple of years before the subprime crisis, IPO volume has been declining since 2004.

***Figure 6*: The Decline in Publicly Listed U.S. Companies**



Source: Letter by James Angel, dated January 14, 2011, to the Securities and Exchange Commission.

Apart from a short rebound of a couple of years before the subprime crisis, IPO volume has been declining since 2004. There was also a decline prior to 2004, in part due to the more stringent and costly corporate governance stipulation contained in the Sarbanes-Oxley Act. IPOs are one of many indicators of the competitiveness of U.S. capital markets.

In addition to IPOs, investment banks also help publicly traded companies raise additional equity capital after they have already gone public. Companies rely on these ***secondary equity offerings (SEOs)*** when they need equity capital beyond what is provided by retained earnings. For example, in 2009 many U.S. banks made secondary equity offerings to raise equity capital to satisfy regulatory capital requirements, because their equity was depleted during the crisis.

IPOs and SEOs allow publicly traded companies to raise capital, grow, and increase employment. The number of publicly traded companies and the amount of capital that they raise are both good indicators of the health of the economy and the prospects

for future employment. From this standpoint, recent developments in U.S. capital markets cause concern. The number of domestic U.S. companies listed on our exchanges has been declining for the past 15 years or so. At the end of 1997, about 8,000 domestic companies were listed on the New York Stock Exchange (NYSE), American Exchange (AMEX), and NASDAQ. This number had dropped to fewer than 5,000 by the end of 2009, and there are now fewer than 4,000 companies in the Wilshire 5000 index of U.S. public companies (see figure 6).[11] This decline, combined with the sputtering volume of U.S. IPOs, suggests that we are creating new public companies at a slower rate than before and that existing public companies are vanishing at a higher rate than new public companies are being created. Although many factors are contributing to this decline, the litigation environment and regulatory and compliance burdens faced by U.S. companies, as well as the passage of Sarbanes-Oxley Act, are significant issues.

Business Financing: Debt

Nonmarket, Intermediated, and Direct Debt

Businesses raise large amounts of financing from debt from a variety of sources. ***Commercial banks*** are traditionally an important source of debt financing. For example, Avolon, an aircraft leasing group, announced in January 2011 that it had raised $2.5 billion in debt since May 2010, the latest coming in the form of $465 million debt raised from a consortium of three leading U.S. banks: Wells Fargo Securities, Citi, and Morgan Stanley. Businesses use banks to obtain short-term, intermediate-term, and long-term debt financing.

Short-term bank financing (typically with loan maturities under one year) is used by businesses to finance *working capital* needs, that is, the cash-on-hand that is needed to pay suppliers, support inventories, and pay other daily bills. Intermediate-term and long-term debt-financing take the form of *bank-term loans*. These are the standard commercial loans with fixed interest rates, set maturity dates, and monthly or quarterly repayment schedules.

Intermediate-term loans usually have a maturity of three years or less. They are generally repaid in monthly installments (in some cases with balloon payments) from the cash flows generated by the sale of goods and services and the collection of cash. In our apple orchard example, Peter would pay off an intermediate-term loan by selling apples and collecting cash from his customers.

A long-term loan typically has a maturity of between three and ten years. These loans are secured (collateralized) by some assets in the business. Operating cash flows are still relied on for making either monthly or quarterly repayments.

In 2009, U.S. banks made more than $7 trillion of commercial and industrial, real estate, and consumer loans, as well as other loans and leases. (see figure 7). This is a very important source of debt financing for businesses.

In addition to making loans, banks also make ***loan commitments*** to businesses. In a bank loan commitment, a bank promises to lend the borrower up to a predetermined amount at a contractually determined interest rate in the future. Typically, commitments are provided for specific uses, such as meeting working capital financing needs or financing an acquisition. As of March 2001, outstanding (unused) bank loan commitments to U.S. corporations stood at $1.6 trillion, so this is a large source of financing.

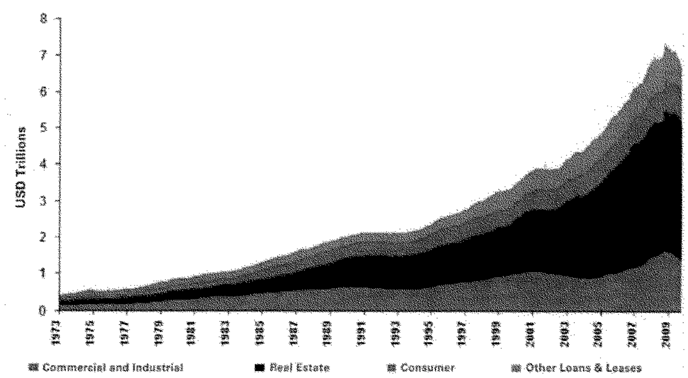
11 Letter by James Angel, to the Securities and Exchange Commission (SEC) http://www.sec.gov/comments/s7-02-10/s70210.shtml (January 14, 2011).

Insurance companies are interested in making long-maturity loans because they need to balance the risk of their long-maturity liabilities, like life insurance policies.

Institutional lenders, such as commercial-finance companies like GE Capital and insurance companies, have been a major source of long-term debt financing for U.S. businesses. Institutional lenders make loans that may be more than 10 years in maturity and thus fill a need at the longer end of the debt maturity spectrum (term loans are typically less than 10 years in maturity). Insurance companies are interested in making long-maturity loans because they need to balance the risk of their long-maturity liabilities, like life insurance policies. By making such long-term loans available to companies, insurance companies help their borrowers improve their risk management. For example, many companies make long-term investments in manufacturing plants (such as Ford or Caterpillar), networks (such as AT&T), and so on. These investments produce cash flows over a long time horizon. The risks in these investments are best managed by financing them with relatively long-maturity liabilities, such as loans from insurance companies. Absent such loans, the management of risks inherent in long-term investments would not be as efficient.

The ***factoring of accounts receivables*** is another source of debt financing that is available to businesses. Every business that sells to customers on credit—the customer purchases the good or

Figure 7: **U.S. Aggregate Lending: Commercial Banks (Seasonally Adjusted)**



Source: www.econographer.com

service but pays at a later date—generates "accounts receivables" when it makes sales. In our apple orchard example, Peter might sell $1,000 of his apples to the school in his town but the school may not pay Peter until three weeks later. Peter would then record $1,000 as a sale on his income statement and $1,000 as an account receivable on the asset side of his balance sheet. The problem with accounts receivables is that even though a sale has been recorded, there is no cash coming in at that time. Sometimes, a company will "factor" its receivables. Specialized factoring companies will provide cash to the manufacturer against that manufacturer's accounts receivables, with a reserve payment set aside, that is, the factoring companies purchase the receivables. After the manufacturer's customers have paid, the factor pays the manufacturer the balance minus an amount representing the factor's discount and interest on the funds originally paid to the manufacturer.

Accounts payable is a similar source of financing provided by the firm's suppliers. Most firms do not pay their suppliers as soon as they receive the goods. It is fairly common practice for firms to pay their suppliers within 30 days of receipt of the goods (e.g., Dell has followed this practice), but some companies take even longer. For example, AB-Inbev, the beer company, has a 90-day payment policy for its suppliers. Whenever a company purchases something but does not pay for it right away, it records the purchase as an expense on its income statement and the amount yet to be paid as a liability, called accounts payable, on its balance sheet. This liability is essentially a form of short-term debt.

The U.S. Small Business Administration (SBA) provides another source of debt financing. The SBA offers long-term financing for purchasing fixed assets. Typically these loans require a personal guarantee from any investor with a stake in the business exceeding 5%.

Public Debt

Thus far we have discussed nonmarket, intermediated, and direct (non intermediated) forms of debt. Companies that have publicly traded debt can also directly access the capital market for borrowing by issuing *public debt* with the help of investment banks. Two main forms of public debt are available to U.S. firms: commercial paper and long-term debt.

Companies that have publicly traded debt can also directly access the capital market for borrowing by issuing public debt with the help of investment banks.

Commercial paper is usually short-maturity (less than one year) unsecured debt financing that is available only to the highest-credit-quality firms. It is typically used for financing accounts receivable and inventory. This is a huge market, with almost $1 trillion in outstanding commercial paper predicted for 2011. At the end of 2009, there were more than 1,700 commercial paper issuers in the United States. Commercial paper is available in a variety of denominations and usually ranges in maturity from 2 to 270 days. It is relatively low-cost (currently, commercial paper rates are less than 0.5% per annum) and hence attractive to companies that can access the commercial paper market. For these companies, it is often an alternative to a short-term bank loan. However, it is also risky because its availability and cost are highly dependent on volatile market perceptions of the firm. For example, in March 2002, Bill Gross, manager of PIMCO Total Return, the world's largest bond fund, said that General Electric (GE) was excessively reliant on commercial paper and that his fund would not buy any GE commercial paper "for the foreseeable future." GE's stock price fell 3.5% after

the announcement.[12] More recently, when the credit market experienced stress during the subprime crisis, the commercial paper market was one of the first to dry up.

Commercial paper is usually a very safe investment because the issuer's financial condition can be reliably predicted over a short time horizon and because only companies with relatively high credit ratings issue commercial paper. The typical denomination for a commercial paper issue is $100,000 or more, which makes direct investment in commercial paper difficult for retail investors. To deal with this, *money market mutual funds* have emerged that invest in commercial paper, allowing investors to invest indirectly by purchasing shares in the mutual fund.

Long-term debt involves bond issues with maturities exceeding one year. While commercial paper is typically used to satisfy short-term liquidity needs of the firm (e.g., financing inventories), long-term debt is used to finance the purchase of fixed assets like machines or acquisitions of other companies. Companies rely on long-term bond financing for a variety of uses and typically pay higher interest rates than on commercial paper. For example, McKesson, the biggest U.S. drug distributor, issued $1.7 billion of 5-year, 10-year and 30-year bonds, as reported in its February 23, 2011, filing with the SEC. Tracking the upward-sloping yield curve, the interest rates were 3.25% on the 5-year bonds, 4.75% on the 10-year bonds, and 6% on the 30-year bonds.[13] As of 2007, the amount of U.S. corporate bonds outstanding exceeded $5 trillion.

In both cases, commercial paper as well as long-term debt, investment banks help firms with the process of issuing debt to capital market investors.

12 CNNMoney. "GE Drops on Gross Comments", http://money.cnn.com/2002/03/21/News/companies/ge/index/index.htm (March 21, 2002).

13 McKesson Corp. Form 8-k, EdgarOnline, http://yahoo.brand.edgar-online.com/displayfilinginfoaspx?FilingID=7757832-4769-12827&type=sect&dcn=0000950123-11-019414.

IV. The Interconnectedness of the Financial System

Two important messages emerge from the description of the financial system. One is that there is a great *diversity* of financing sources available to individuals and businesses seeking financing. And the other is that the different components of the financial system are *interconnected*.

Why do we need such a diverse set of financing sources? The simple reason is that the greater the diversity, the more effectively the financial system can meet the needs of individuals and businesses. For example, suppose that the only mortgages available were 30-year fixed rate mortgages. These might meet the needs of individuals who wish to lock in an interest rate for a long period of time. But what about the person who believes interest rates might fall in the future or whose financial condition is likely to improve over time so he would be able to afford higher interest rates in the future? Such a person would prefer a variable or adjustable rate mortgage, in which the interest rate fluctuates with market rates, or one that that has a lower initial rate and a higher subsequent rate. A greater variety of mortgages accommodates a greater variety of individual preferences and needs.

Like individuals, businesses have a diverse set of needs. Some face a great deal of uncertainty in their core business model and prefer to finance largely with equity in order to limit the bankruptcy risk associated with debt. Other firms invest heavily in R&D and have substantial intellectual property that they wish to protect. Such firms will also tend to finance primarily with equity to minimize bankruptcy risk. Microsoft is one example. Other examples are drug companies such as Merck that invest heavily in R&D. These firms tend to have low debt/equity ratios in their financing mix.

Why do we need such a diverse set of financing sources? The simple reason is that the greater the diversity, the more effectively the financial system can meet the needs of individuals and businesses.

The reason that firms such as Microsoft and Merck, which have intellectual property to protect, tend to use relatively low amounts of debt is that an increase in debt financing brings with it a higher likelihood that the firm will be unable to meet its repayment obligation or violate certain debt covenants. For example, as we saw in the subprime crisis, homeowners who defaulted on their mortgages were those who had higher loan-to-value ratios than others, because higher indebtedness meant larger monthly mortgage payments and hence a lower ability to make the payments when faced with a decline in income. The same is true for companies. When there is a covenant violation or default on a repayment obligation, the firm may be forced to either sell assets (some which may have valuable intellectual property) or declare bankruptcy (in which case ownership of the intellectual property might transfer to the creditors).

Even within the spectrum of a specific form of financing like equity or debt, diversity plays an important role. Consider equity first. Some firms prefer to finance primarily through retained earnings because it is important for them to avoid the ownership dilution associated with issuing equity. Yet others, especially those firms that are growing rapidly, will

find that relying solely on internally generated equity is not enough to support their growth. Such firms will wish to use external equity financing. And in this respect, the more diverse the sources of external equity finance, the better. For example, a firm may be seeking equity to help finance its growth in a market in which it is selling a product for which it has developed a proprietary technology. Such a firm may not wish to issue equity in the *public* market because it would have to disclose sensitive information about its technology, due to the information disclosure requirements of the securities exchange. While the information is disclosed primarily for investors, it is also necessarily revealed to competitors at the same time. To avoid this, the firm may wish to use a private placement of equity to raise external equity capital. If the private placement option were not available, the firm might prefer to forgo issuing equity and expanding in order to protect the confidentiality of its proprietary technology. It is easy to think of examples. Facebook raised private equity at a time when it would have found it difficult to raise public equity. Similarly, Intel raised private equity from IBM, a customer, rather than issuing public equity. Although IBM has divested most of its holdings in Intel, at one time it owned 20% of the company.

By contrast, other firms might be more interested in a public sale of equity—either through an IPO or an SEO—because publicly traded equity provides greater liquidity and typically has a lower cost of capital associated with it than private equity. Moreover, public equity also helps with employee motivation and retention. For example, having publicly traded equity allows companies like Microsoft and Starbucks to compensate their employees with shares of stock. When Microsoft's stock price was rising rapidly in the 1990s, this was very attractive to its employees and it allowed Microsoft to attract and retain high-quality talent. Starbucks takes stock ownership right down to the employees in its retail stores. These employees understand that if they work hard and provide the best customer service, Starbucks' stock price will go up. Such employee stock ownership is valued more by employees when they can sell their stock in a liquid public market than when it is privately held.

Diversity of financing sources is also important for businesses seeking debt financing. Sometimes firms have short-term borrowing needs. They would tend to satisfy these needs through accounts payable financing, accounts receivable factoring, or bank loan commitments. Larger firms with impeccable credit ratings may choose to augment these short-term financing sources with commercial paper financing. The availability of diverse short-term financing sources permits firms to match quite precisely their specific needs to the financing source. The result is that more short-term financing needs are met than would be possible with fewer financing sources. Consequently, firms invest more.

At other times, firms have longer-term debt financing needs. A firm may be investing in a new factory that has an anticipated economic life of 20 years. For such a long-term investment, it will seek a long-term loan. If only short-term debt financing were available, the firm might pass up the investment opportunity.

Firms sometimes finance acquisitions with debt. For example, InBev's purchase of Anheuser Busch, the largest U.S. beer manufacturer, was financed predominantly with debt. In such cases, the firm may wish to match the maturity structure of its debt with the pattern of cash flows it anticipates generating after the acquisition. This, too, typically calls for long-term debt financing.

A diverse set of financing sources also enables firms to strike the appropriate balance between the cost of debt financing and liquidity

A diverse set of financing sources also enables firms to strike the appropriate balance between the cost of debt financing and liquidity risk.

risk. Since long-term debt financing is usually more expensive than short-term debt financing, pure cost considerations would push the firm in the direction of short-term debt like commercial paper or a short-term bank loan. But short-maturity debt also exposes the firm to liquidity risk because it may not be able to roll over its short-term debt. A recent example of this is Bear Stearns, the investment bank. It was financing itself with debt of one-month maturity that was rolled over every 30 days. When concerns about its hedge-fund losses became sufficiently grave, this 30-day debt financing evaporated, and the bank was on the brink of insolvency before its government-assisted takeover by JPMorgan Chase. Firms are constantly trying to balance the cost of borrowing against liquidity risk, and a diverse set of financing sources helps them to achieve the right balance.

A greater diversity of financing sources helps individuals and businesses to:

- improve their management of risk and achieve a better balance between the cost of financing and risk; and
- increase investments, and thus employment in the economy.

It is useful to note that the different parts of the financial system are intimately interconnected. For example, venture capital and private equity are available in part because we have such deep and relatively efficient capital markets. PE and VC firms make their investments with the expectation that they will eventually exit by taking these firms public and selling off their ownership shares. If our public equity markets were to diminish in the future, perhaps because of excessively onerous regulation, it is very likely that the supply of PE and VC financing would decline as well. Without the attractive "exit option" provided by the public equity market, PE and VC firms would view their investments as lacking the potential to be "liquefied" in the future via an IPO, and would therefore scale back on their investments. Clearly, some capital market regulation is necessary to ensure transparency and integrity, and this improves the efficiency and attractiveness of the market. But when it becomes excessive, it can drive firms away. Thus, more onerous capital market regulation might reduce investment in small and mid-sized companies and lower aggregate employment.

Similarly, good public equity and debt markets allow banks to raise debt and equity capital to support their own growth. This, in turn, enables banks to extend loans that support the financing needs and growth plans of individuals and businesses. If burdensome new regulatory requirements made bank capital more expensive, bank lending would decline. The consequence would be lower GDP growth and employment.

Indeed, given the interdependence between banks, markets, and among the different components of the market, if one financing source were to disappear, it would have potentially devastating consequences for other parts of the financial system.[14] This can be seen most vividly in emerging markets. When Romania converted from a centrally planned, Communist-run economy to a free-market economy, the housing market was underdeveloped. It was difficult to jump-start this market even in the new free-market economy because banks were reluctant to lend to consumers to buy houses. This reluctance

14 See Song and Thakor (2010).

arose from the inability of banks to securitize home mortgages because the securitization market did not exist in Romania the 1990s.[15] Thus, the absence of the securitization market stunted the growth of the home mortgage market.

Even within the United States, we have seen numerous examples of this. Many U.S. corporations, especially non-depository financial companies, rely on the repo market for their short-term funding needs. The repo market, whose precrisis size is estimated at between $10 trillion and $20 trillion, involves a firm taking a short-term loan (typically overnight loans) from another firm under a repurchase agreement in which eligible securities are used as collateral. So, I might have $100 worth of marketable securities against which I might borrow $100 from you for, say, a day. When I repay the loan, I get my securities back (I "repurchase" them). If I default, you keep the securities. Repos have "haircuts" associated with them. If I can borrow $100 against $100 worth of securities, the haircut on the repo is 0. If I can borrow only $90 against $100 worth of securities, the haircut is 10%, and so on. It is estimated that between early 2008 and early 2009, the haircut on repos went from 0 to 45%.[16] If one takes the simple average of these two numbers as the average haircut during this period, then one can estimate that about $2.25 trillion in short-term borrowing capacity vanished fairly quickly from the market as companies were now able to borrow that much less using the same collateral as before. This led to a significant decline in lending to individuals and businesses, as a major part of our financial system found itself to be liquidity constrained.

This example illustrates both interconnectedness and the danger in making changes in one part of the financial system. One reason that repo haircuts went up is that bad news began to trickle in about defaults on home mortgages, and many of the securities being used as collateral in repos were mortgage-backed securities. Thus, what happened in home mortgages affected short-term credit availability to financial firms, which then spilled over into a general decline in the credit available to businesses and individuals.

Imagine what would happen to U.S. credit card lending if the market for credit card securitization were to disappear. Millions of consumers would find themselves without access to credit cards. Similarly, imagine what would happen to entrepreneurs if venture capital were to disappear. Scores of new businesses would fail to be launched.

When the components of the financial system are so interconnected, even small initial changes in one part of the system can reverberate through the entire system and manifest as big eventual changes.

The "theory of unintended consequences" says that it is difficult to predict how the financial system will react if one of its components is tinkered with via regulatory changes. When the components of the financial system are so interconnected, even small initial changes in one part of the system can reverberate through the entire system and manifest as big eventual changes. For example, when the Federal Reserve injected substantial liquidity into the economy from 1995 through 2005, it was hard to imagine that this would contribute to a housing price bubble and crisis. Such unintended consequences are also encountered in other parts of the economy.

15 See Meyendorff and Thakor (2002).

16 See Gorton and Metrick (2010).

For example, not many would have predicted that the "cash for clunkers" stimulus initiative would have the unintended consequence of hurting automobile parts suppliers and putting many of them out of business. Interconnectedness magnifies the errors embedded in regulatory missteps and increases the uncertainty generated by them.

The effects of this interconnectedness can spill over into different types of financing. For example, suppose that banks find their equity capital has been depleted because of credit and trading losses such as those that we witnessed during the recent crisis. At the same time, it might be more difficult to access public equity markets for more capital because the market is stressed and investors are averse to purchasing additional equity in banks. A consequence of this would be a decline in bank lending, similar to the 7.5% decline in U.S. bank lending witnessed in 2009.[17] Another consequence would be a decline in new lines of credit (or loan commitments) extended by banks. Because companies use lines of credit from banks extensively to back up commercial paper issues, U.S. corporations would suffer a "double whammy" in the sense that they would not only have diminished access to bank loans, but also lesser access to the public debt market. In this way, adverse developments for banks in the market for bank equity capital can spill over into the debt market for other firms. Aggregate investment, employment, and GDP suffer as a result.

This interconnectedness is one of the main reasons why regulatory intervention in one part of the financial system so often generates unpredictable and undesirable consequences in some other part of the financial system. Consider what happened when the Dodd-Frank Act effectively expanded the legal liability on credit rating agencies for "rating misrepresentation." The three major U.S. credit rating agencies responded by asking debt issuers to not use their ratings. However, by SEC regulation, these debt issues needed ratings, so the market for these issues essentially froze for a few months. Scores of debt issuers were denied access to much needed funds. Such are the workings of the theory of unintended consequences.

This interconnectedness is one of the main reasons why regulatory intervention in one part of the financial system so often generates unpredictable and undesirable consequences in some other part of the financial system.

17 Statement of Martin J. Gruenberg, Vice Chairman FDIC, on Condition of Small Business and Commercial Real Estate Lending In Local Markets, FDIC, http://www.fdic.gov/news/news/speeches/others/spfeb2610.html (February 26, 2010).

V. Conclusion

This paper has surveyed the U.S. financial system from the standpoint of the various types of financing sources available to individuals and businesses and the different types of financing arrangements (contracts) by which capital is raised. The main messages emerging from this discussion are as follows.

First, the financial system helps economic growth. This is achieved through the provision of four basic services: facilitating trade; facilitating risk management for various individuals and businesses; mobilizing resources; and processing information about individuals and businesses and allocating resources.

Second, individuals (consumers) are largely limited to debt financing for raising capital. Nonetheless, consumers can use a large number of sources to raise this financing, including banks, finance companies, and the federal government.

Third, businesses regularly access both debt and equity capital, and the appropriate mix of debt and equity, called the "capital structure" decision, is a key strategic choice for any company. Businesses have three basic sources of capital: private, intermediated sources, and public markets. These three categories exist for both debt and equity capital. In private non-intermediated sources, the firm raises financing outside the public capital market without using a financial intermediary like a bank. Included in this are sources like friends and family, cash generated from the firm's operating profits, customers, and suppliers. Private intermediated sources include bank loans, borrowing from finance companies and insurance companies, and loans from the parent company. Public market access includes going directly to the capital market to raise money, such as through a commercial paper or public debt issue.

Fourth, a rich variety of debt and equity financing sources is available in the United States. This diversity is crucial for helping our economy to keep its competitive edge because it enables businesses to improve their management of risk and lower their cost of capital, so that both investment and employment increase.

Finally, the U.S. financial system is highly interconnected. This interconnectedness means that any changes in one part of the financial system—either through a shock like a crisis or through regulatory intervention—can reverberate throughout the entire system, often in unpredictable ways. As a result, well-intentioned initiatives may produce more harm than good.

This paper has not addressed some questions. What does the future hold for financial services? What effect will the Dodd-Frank Act have on the financial services industry? Will the industry experience an increase or decrease in the diversity of financing sources in the future? How will the regulatory structure evolve? These are interesting questions to ponder, and the answers will not only influence how we deal with global challenges but also determine the magnitude of future economic growth because of the close relationship between financial system development and economic growth, discussed in this paper. The world's population is growing and is likely to hit 9 billion in this century. This growth will put substantially greater stress on the natural resources needed to support this population—food, water, and energy. Innovations of all sorts will be needed to optimize the

use of limited resources and harness new resources. These innovations will need to be financed. A vibrant and robust financial system in the United States will play a critical role in supporting these innovations and helping them to become commercial successes. The Microsofts, Googles, Genentechs, and Facebooks of tomorrow will rise from the commitment to innovation that will be fueled by the financial services sector in the United States and elsewhere. Financial markets in emerging countries like India, China, and Brazil will continue to grow and challenge the preeminence of U.S. financial markets. Already, two-thirds of the world's equity market capitalization is *outside* the United States. Global competition among financial markets is sure to intensify even further. Thus, business will go to the most transparent and well-regulated markets, and will flow away from markets that are more onerously regulated and involve higher costs of capital. As long as economically sensible regulation supports the transparency and health of the U.S. financial system, the economic growth that will follow the wave of future innovation will be accompanied by growth in the depth and size of the U.S. financial services industry and the economic value provided by it.

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IssuWorks

Hearing on Legislation to Further Reduce Impediments to Capital Formation

Statement of David Weild, Founder, Chairman & CEO of IssuWorks Holdings LLC, before the U.S. House of Representatives Financial Services Committee, Capital Markets and Government Sponsored Enterprises Subcommittee, October 23, 2013.

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Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee, thank you for inviting me to speak today about an issue of great importance to many Americans: "Legislation to Further Reduce Impediments to Capital Formation."

My name is David Weild. I am the Chairman & CEO of IssuWorks Holdings ("IssuWorks"), which was recently founded to develop technologies to improve capital formation in the public markets. I was formerly vice chairman of The NASDAQ Stock Market with responsibility for all of its listed companies, and I ran the equity new issues business of Prudential Securities, back when Prudential Securities was one of the ten largest underwriters of new issues equities in the United States.

Improving access to equity capital in the United States is one of the most important needs for our economy. Access to equity capital fuels job growth and innovation, which, in turn, enables free markets to solve problems from poverty and unemployment to finding cures to cancer, global warming and many of the other challenges that this generation, and every other generation, will face.

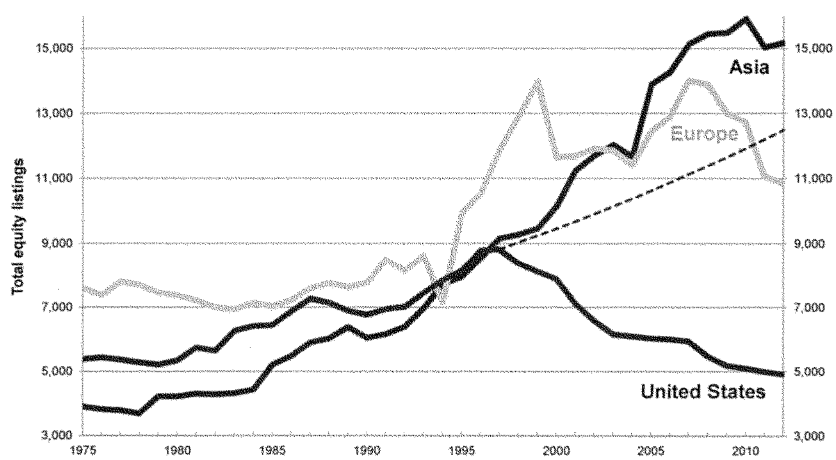
I'd like to start by thanking you for the terrific bipartisan work that culminated with the signing into law of the JOBS Act on April 5, 2012. I know what an integral part so many of you played in making the JOBS Act a reality. But, while the JOBS Act created so-called "On-Ramps" to facilitate companies getting public, it did nothing to improve the aftermarket for these companies and their investors. One might legitimately ask, "Have we created the "On-Ramp to Nowhere?" So with this in mind, I would like to convey my view that we have much more work to do. The American people will need the equivalent of a JOBS Act 2 and 3 if we are really going to restore the innovation and job creation engine to the US economy that once made US stock markets the envy of stock markets the world over.

Specific responses to legislative proposals

H.R. , To amend the Securities Exchange Act of 1934 to provide for an optional pilot program allowing certain emerging growth companies to increase the tick sizes of their stocks. (Mr. Duffy)

This is the most important Bill in this package for its potential to improve capital formation broadly and to create jobs in the United States. Our listed stock markets are in the midst of a long-term and protracted collapse which has been self-inflicted. As seen from recent data compiled by the CFA Institute's Jason Voss, the United States today has fewer publicly listed companies than we did at any point since 1975 (see Figure 1).

Figure 1: U.S. stock market listings have collapsed since 1997
The United States has fewer than 4,900 listed companies when it should be approaching 13,000.



Sources: Jason Voss, CFA Institute (cited by Bloomberg Finance, Oct. 11, 2013) and IssuWorks

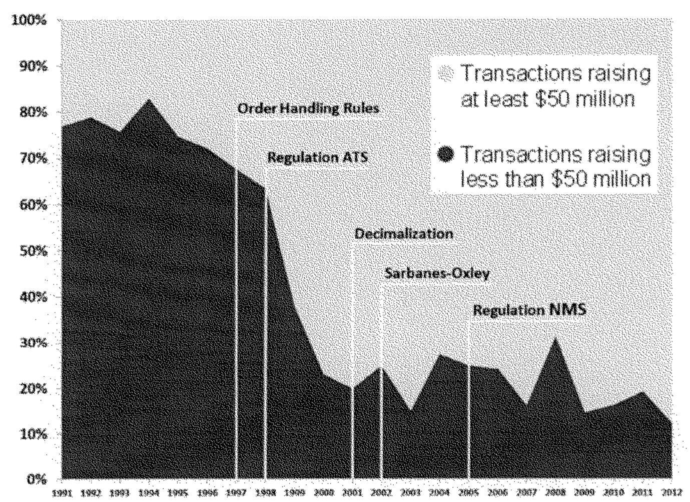
In fact, we have less than 4,900 publicly listed companies, when we should have closer to 13,000 public companies, but for the fact that changes to market structure gutted the aftermarket support model in 1997 with the implementation of the Order Handling Rules

followed by the shift to electronic markets in 1998 with Regulation ATS (Alternative Trading Systems) and one-size-fits-all penny stock trading in 2001 with "Decimalization" (see Figure 2).

Consumer activists that promote low cost trading in innately illiquid (small-, micro- and nano-cap) stocks are trafficking very bluntly in "Fool's gold." Low cost trading in illiquid stocks perversely harms consumers by depriving them of higher disposable incomes while wreaking havoc on the lowest socioeconomic classes of our society.

Low-income groups which are disproportionately made up of minorities, single mothers, blue collar workers, many union workers, older Americans, and kids graduating from college are not day trading stocks.[1] None of these groups benefit from this market structure. Indeed, they are all harmed by this market structure inasmuch as it deprives them of employment opportunities and higher disposable income.

Figure 2: The acceleration to electronic markets in 1998 (Reg. ATS) triggered a wholesale the collapse in economic incentives to support small cap stocks which, in turn, gutted the small IPO market.



Sources: IssuWorks and Dealogic.
Data includes corporate IPOs as of Dec. 31, 2012, excluding closed-end funds, REITs, SPACs and LPs

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[1] For example, according to statistics from the Economic Policy Institute on asset ownership by race and ethnicity, the average dollar value of stocks owned by Black and Hispanic households was $12,300 and $10,800, respectively, in 2010, while the median dollar value of stocks owned by both groups was $0. See http://stateofworkingamerica.org/chart/swa-wealth-table-6-8-average-median-assets/.

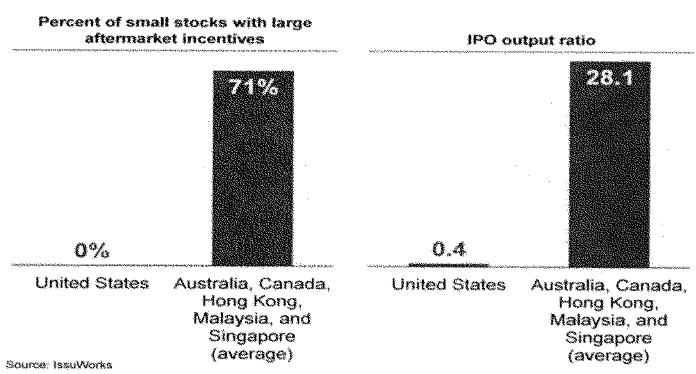
It takes no great leap to understand that the loss of the so-called "Multiplier effect" in job creation, where as many as five service sector jobs are created for every technology job[2], is exacerbating the disparity between the "haves" and "have nots" of our society. Poor people don't day trade stocks, but they do need a robust economy that will create jobs. People at the lower end of the economy are the "LIFOs" in our job market: Last in, first out. When we have a slack economy, they suffer most.

It also takes no great leap to understand that the great growth companies of tomorrow, the great innovators of tomorrow, those very companies that will find the cure to Alzheimer's and global warming and advance the technologies for sourcing renewable energy, need a United States IPO market that is as vibrant as it used to be when companies like Intel, Microsoft and Amgen went public.

In our work for the OECD comparing the top 26 IPO markets in the World, it became crystal clear that the IPO market in the United States collapsed from what today should be on the order of 900 IPOs per year to levels which have averaged 135 IPOs a year since 2000. Today, of the top 26 IPO markets, the United States is ahead of only Mexico and Brazil in GDP-weighted small IPO production.

Today, the United States has the lowest aftermarket incentives of any market as measured by how many micro-cap stocks offer tick size incentives that are greater than 1% of the share price. In the United States, zero (0) micro-cap stocks have tick sizes greater than 1% of share price while stock markets that dramatically outproduce the United States in small IPOs on a GDP weighted basis – including Australia, Canada, Hong Kong, Malaysia and Singapore (see Figure 3) – have fully 71% of their micro-cap stocks with tick sizes in excess of 1% of share price.

Figure 3: The U.S. has the lowest aftermarket incentives of any market in the world



We have been penny wise and pound foolish in our efforts to save consumers money on transaction costs, and if we do nothing to improve the aftermarket, we have built an "IPO

[2] Moretti, Enrico, Professor of Economics, University of California, Berkeley, *The New Geography of Jobs*, 2013

On-Ramp to Nowhere." We not only support this bill, we believe that this Bill needs to go further:

- In addition to 5 cent and 10 cent tick size options, we believe that nano-cap stocks – defined as stocks under $100 million in market value – may need a 20 cent tick size option.
- We believe the Bill should require that trading be done only at the outer bounds of minimum tick size increments (not within the tick increment)
- We believe that there should be no payment for order flow allowed that would make a mockery of the intent of this structure.

While this may be controversial, the fact is that in an "Issuer choice of tick size" model, investors are invited to "Vote with their feet." They don't have to invest in these stocks if they don't want to. And, the vast majority of equity market value that is large-cap will still trade at penny tick size increments – thus satiating special trading interests.

Too many people on Wall Street fight to increase their slice of the pie without working to grow the size of the pie. These changes are essential to growing the pie. They will lead to more liquidity... which will bring more institutional investment... which will raise stock prices in smaller stocks... leading to more IPOs and more job creation that will grow the economy.

However, one thing is clear, that at current rates of decline in the IPO market, if we do nothing, investors will have fewer and fewer choices in public companies: Today, there are already fewer than 3,700 operating companies in the Wilshire 5000 index.

We urge Congress to come together in the same bipartisan manner that brought us the JOBS Act, to finish the job and develop the essential "JOBS Act 2" that will restore aftermarket support and brings U.S. IPO markets back to where once again, the United States stock markets will rightfully be the envy of stock markets the World over and Americans may be put back to work.

Business Development Companies (H.R. 1973, 1800 and 31 broadly)

We generally support the thrust of these three bills.

Business Development Company ("BDC") rules are antiquated and should be modernized to support streamlined filing practices, including shelf registrations, that are the customary practice for operating companies. BDCs typically lend money to businesses, and, in a world where banks are required to maintain higher regulatory capital ratios, there is a public interest to be served by streamlining the capital raising activities of BDCs (to use shelf registrations as is indicated by H.R. 1800) and widening their scope of investment (as is indicated by H.R. 1973) to make financial services companies, including community banks, leasing companies, factoring firms, and automobile financing companies so-called "Qualifying" investments.

A policy that limits BDC investments to no more than 30% of small- and medium-sized financial services companies runs counter to the objective of helping attract capital for the benefit of small- and medium-sized American companies, since these financial institutions may in turn lend money to other businesses. In fact, we could easily foresee BDCs that are dedicated exclusively to investing in financial institutions as being something clearly in the public interest in light of the aftereffects of the Financial Crisis of 2007-2008.

However, since BDC shares are widely held by retail investors, and both both H.R. 1800 and H.R. 31 would increase the ability to leverage BDCs, from a current ratio of $2 of assets to every $1 of equity to $1.5 of assets to every $1 of equity, we would like to see portfolio stress tests before we endorse any increase to leverage limits. A higher leverage ratio may boost yields to investors and result in an increase in share price values which would allow BDCs to raise more equity capital. Increased leverage applied to these portfolios, while increasing the potential for return, will also increase downside risk, and we believe that the Sub-Committee would be wise to understand fully how BDCs might perform when fully leveraged in a variety of environments that include inverted yield curves (where short-term liabilities of such funds are higher than the yields of long-term assets) and periods of higher corporate defaults, financial crisis (such as the Financial Crisis of 2007-2008) and recession.

H.R. 2274, Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013

We support H.R. 2274 because it creates clarity in the regulation of the M&A market. M&A advisory firms that took the conservative approach of registering with FINRA have been frustrated by those many firms that transact in the M&A market without a FINRA registration. Most types of M&A, especially in private markets, pose very little risk to the public: Transactions are negotiated among professionals and/or business owners who conduct their own due diligence. It is widely accepted that these transactions should be held to what has been called a "Broker-dealer lite" standard. For the reason that all participants should adhere to the same set of rules and that these rules should not be unduly burdensome, we support the formation of a new regime, overseen by the SEC, as contemplated by H.R. 2274. However, we believe that the Bill should explicitly state that FINRA-Registered Broker Dealers could also file with the Commission under H.R. 2274 as an M&A Broker and that qualifying transactions would be subject to no additional review by FINRA.

H.R. , To direct the Securities and Exchange Commission to revise its regulations relating to requiring the use of eXtensible Business Reporting Language for periodic reporting to exempt smaller public companies from such requirements. (Sponsor Not Named)

I helped organize the first demonstration of XBRL while vice chairman of NASDAQ. We did this for a group of semiconductor companies. We generally applaud the intent of XBRL. However, requiring smaller issuers to bear the costs of services that largely

benefit investors, especially large ones, is not fair and will only cause companies to avoid going public. We believe that the cost is better borne by investors and not the companies. We also believe that a transaction tax model, or subscription to XBRL model, would better serve the purpose of acquiring funds to pay for the cost of XBRL tagging of smaller companies' data. Smaller issuers need reduced costs to incentivize them to go public. Absent an alternative, we support exempting smaller public companies from the requirement to file XBRL-enabled financial statements.

H.R. , To amend certain provisions of the securities laws relating to the treatment of emerging growth companies. (Mr. Fincher)

We support this Bill as it creates generally greater optionality for issuers without altering the ultimate level of required disclosure to investors. This Bill is in keeping with the philosphy that underlies Title I of the JOBS Act and the creation of safe harbors such as "Testing the waters" and "Confidential filings." We believe, for example, that providing issuers with the ability to file without full financial statements will cut issuer time-to-market which is beneficial in mitigating market risk and speeding access to capital.

Call for a *JOBS Act 2* (Significant ways Congress can help the U.S. economy)

We take this opportunity to offer a range of ideas to improve the long-term effectiveness of the JOBS Act:

Title I of the JOBS Act – Emerging Growth Companies

We continue to believe that the single most critical impact on capital formation in the United States will be had by improving aftermarket incentives so that small-, micro- and nano-cap market makers will compete on the provision of value (e.g., capital commitment, sales coverage, and research coverage) and not on price. Whether this is done by increasing tick sizes (and eliminating incentives to engage in price competition through such practices as payment for order flow, rebates and price improvement by trading within the tick), or the wholesale creation of new market structures, is less important than the realization that current market structure has had a catastrophic impact on capital formation and the U.S. economy.

Please see views expressed above in the section entitled, "Specific responses to legislative proposals" where we generally endorse the Bills intended:

- "To amend the Securities Exchange Act of 1934 to provide for an optional pilot program allowing certain emerging growth companies to increase the tick sizes of their stocks." (Mr. Duffy)
- "To amend certain provisions of the securities laws relating to the treatment of emerging growth companies." (Mr. Fincher)

Title III of the JOBS Act – "Crowdfunding"

Professor John Coffee of Columbia University, in riveting testimony before the Senate, dubbed Crowdfunding the "Boiler room act of 2011." This understandably caused concern.

We submit that Crowdfunding Portals should be thought of differently, and treated separately, from broker-intermediated offerings under Title III of the JOBS Act. Crowdfunding Portals represent a paradigm shift in how securities, products and causes will be vetted and sold. The collective intelligence and scrutiny of the "Crowd" will result in dramatically lower rates of fraud, for example, than the tradtitional broker-intermediated sales process. One need only recall that when peer-to-peer auction markets such as eBay came into being, there were similar concerns

over the risk of fraud. The portal (eBay), in order to grow, had to master quality control, which it did by being responsive to its users and harnessing the power of the Crowd.

We also believe that Crowdfunding has the potential to transform access to capital for small business. For these reasons, we recommend that Congress:

- Eliminate the $1 million cap on Crowdfunding that takes place on Portals. There are already limits in place on the amount that an investor can commit to any one investment. Two layers of protection are unnecessary in our view.
- Consider tax credits for investment in minority- and women-owned businesses, businesses where minorities and women make up a majority of employees, and businesses that are concentrated in targeted development zones. We believe that Crowdfunding and entrepreneurship, combined with tax incentives could be a powerful mechanism to incentivize "haves" to invest in "have nots" and thereby use free markets as a way to transform some of the structural challenges facing our society.

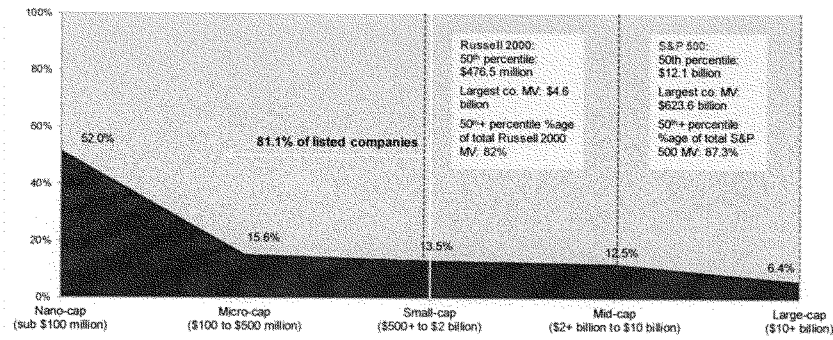
Title IV of the JOBS Act- Popularly known as "Reg. A+"

Need for a Reg A+ Blue Sky Exemption - Background - Reg. A+ is a stripped down (documentation) form of IPO for smaller offerings (a maximum of $50 million in proceeds) where public investors are solicited under a private placement exemption and where shares may be traded freely in the aftermarket (subject to State or "Blue Sky" limitations). Under Title IV of the JOBS Act, the cap on this exemption was raised from $5 million in proceeds to $50 million in proceeds. "Bad Actor" prohibitions and certain reporting and disclosure enhancements (e.g., audits) were added. However, the concern is that this Title (the SEC still has not issued the rules) will not find widespread use unless a Blue Sky (state filing) exemption is permitted. (note- the increase in aftermarket economic incentives through an increase in tick sizes or other structural change will be critical to Reg. A+ transactions working as well).

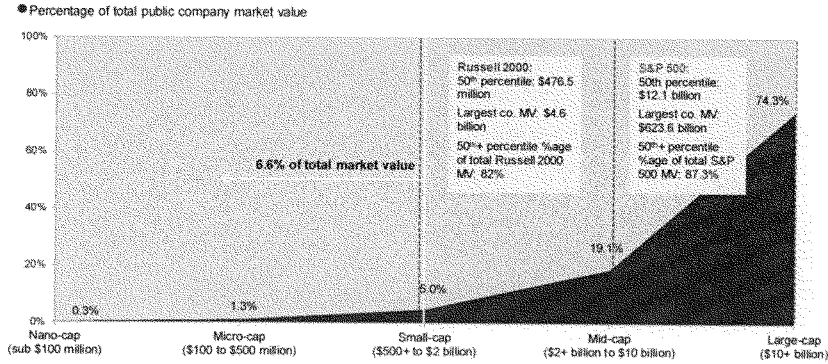
Possible legislative mechanism – Congress could make Title IV securities "Covered securities" under Section 18(b)(4) of the Securities Act of 1933 which would exempt these Securities Offerings under Title IV of the JOBS Act from State regulation. This small change would help ensure that Reg. A+ would fulfill its promise.

Creating a Core Competency to Protect and Sustain Small Company Markets

The drive to create one-size-fits-all stock markets with low transactional costs to benefit stock purchasers is at the heart of the collapse of the IPO and listings markets in the United States. Small-, micro- and nano-cap markets are fundamentally different in nature from large capitalization markets and yet their interests are often drowned out of the discussion for the simple reason that while they make up 81.1% of all listed companies, they only account for 6.6% of total market value. Market value is concentrated in larger (large-cap and mid-cap) stocks while capital formation, growth and innovation is concentrated in smaller stocks.



Sources: IssuWorks and Capital IQ
Includes NASDAQ, NYSE (including AMEX) and OTC listings. Corporate issuers only, excluding holding companies, funds, MLPs, SPACs, REITs and other trusts.



Sources: IssuWorks and Capital IQ
Includes NASDAQ, NYSE (including AMEX) and OTC listings. Corporate issuers only, excluding holding companies, funds, MLPs, SPACs, REITs and other trusts.

We recommend the creation of a horiziontally-integrated small capitalization division within the SEC. This division would include under one roof, all three major disciplines including:

- Corporation Finance
- Trading and Markets
- Enforcement

Small cap markets are neglected because there is insufficient dedicated representation of the needs of small cap market structure. Prior to Reg. ATS, the stock exchanges performed this function by protecting market structures that would support capital formation and small cap

stocks. At NASDAQ, it was through the dealer system and higher spreads. At the NYSE, it was through the allocation system (specialists were forced to subsidize liquidity and support small cap stocks that were assigned to their "Book."). With the flood of new entrants from Reg. ATS and the competition that ensued after the advent of Decimalization and Regulation NMS (National Market System), the one-size, hyper-competitive trading model caused the stock exchanges to lose the ability to effectively fight to preserve market quality for small-cap stocks. Today, neither the SEC nor the Stock Exchanges provide a holistic discipline focused on nurturing the small-, micro- and nano-cap ecosystems. At the SEC, to the best of our knowledge, only the Division of Corporation Finance has a formal small company discipline. Without control over market structure and enforcement, that discipline has proven to be ineffectual.

By creating a horizontally integrated small-, micro- and nano-cap discipline at the SEC, with authority to optimize market structure for the benefit of the broader ecosystem of investors, intermediaries and issuers, market structure would avoid again being led down a path that compromised U.S. economic growth.

I have had occasion recently to present to the Investor Advisory Committee of the SEC. Again, I am struck by the fact that this committee is made up of mostly large-cap oriented, quantitative and index-oriented investors that have little-to-no direct experience in the fundamenal investing in, and trading of, small and micro-cap stocks. We believe that the SEC needs an Investor Advisory Committee made up exclusively of fundamentally-oriented investors in small-, micro- and nano-cap stocks.

Conclusion: IPOs lead to job growth

A capital market is a multi-layered, complex ecosystem of competing and related interests. Each of the numerous constituents must be governed by rules and encouraged by incentives. The markets that succeed in balancing these many interests are the markets that will go the furthest in facilitating capital formation. Efficient markets need to do more than create rock-bottom trading costs for market speculators — they also need to improve the allocation of capital and enhance long-term economic growth.

If the rules become too burdensome, or if the incentives become diminished for any party, the ecosystem operates far below its potential efficiency. Companies have difficulty reaching new investors, innovation and job creation slows or stops altogether, and the macro economy suffers.

A vibrant capital market is the engine of a healthy economy that creates jobs. We estimate that, if not for the scarcity in public offerings, 3.1 million to 9.4 million additional U.S. jobs might have been created by companies after going public. If we assume a multiplier effect where higher IPO activity accounts for a like-kind number of jobs created in the private market (a conservative effect of only one for one), the range of 3.1 million to 9.4 million jobs created jumps to between 6.2 million and 18.8 million.

A major contributor to employment

In fact, the so-called multiplier effect may be much larger than we estimate above. Enrico Moretti has estimated that as many as five local service sector jobs — ranging from doctors and teachers to wait staff and sales clerks — are created for every one technology and biotechnology sector job produced.[3]These are the very industries that once sought out public offerings as their preferred strategy to raise capital (and exit). This five-to- one ratio of job formation has served to increase the number of employment opportunities at all skill levels and, ultimately, the U.S. standard of living.

[3] Ibid.

Congressional support is needed

Congress has the power to help reverse our current situation and bring back the stock market that was once the envy of economies throughout the world for its ability to foster U.S. economic leadership. To grow the IPO markets – currently the key exit path putting pressure on access to capital in private markets – we need Congress to focus its attention on the so-called "Aftermarket support model" – the incentives required to sustain visibility and institutional liquidity in small-, micro- and nano-cap stocks.

We understand that it will not be easy. There are many entrenched interests that would prefer to argue over how to increase their share of the "pie" rather than to focus on how to grow the "pie" for all Americans. Unfortunately, those that can least afford to bear the brunt of a soft economy have been dealt the harshest blow by the folly that is one-size-fits-all stock markets.

Additional materials

The collapse in economic incentives to support small-, micro- and nano-cap stocks precipitated a collapse in the ecosystem of investment banks that acted as book running managers in 1994 verus 2012. Firms in red from 1994 (see below) were no longer in business in 2012. The number of book-running managers (so called "On-ramps") contracted dramatically.

Small-cap companies and capital formation			
	Before 1997	After 2001	% change
Tick sizes ("bankable spread")	$0.25 per share	$0.01 per share	-96%
Retail commissions	$250 per trade	$5 per trade	-98%
Investment banks (acting as a bookrunner)	167 (1994)	39 (2006)	-77%
Small company IPOs	2,990 (1991–1997)	233 (2001–2007)	-92%

Source: IssuWorks

1994			2012
AB Capital & Investment	Harriman Group Inc	Paragon Capital Markets Inc	Allen & Co LLC
Advest Inc	Harris Nesbitt Gerard Inc	Paribas Capital Markets	Ameriprise Financial Inc
AG Edwards & Sons Inc	HJ Meyers & Co Inc	Parker/Hunter Inc	BofA Merrill Lynch
Allen & Co LLC	Howe Barnes Investments Inc	Patterson Travis Securities	Barclays Capital Inc
Americorp Securities Inc	IAR Securities Inc	Paulson Investment Co Inc	BMO Capital Markets
Anderson & Strudwick	ING Barings	Piper Jaffray & Co	Capitol Securities Mgmt
AR Baron & Co Inc	International Assets Advisory	Principal Financial Securities	Chardan Capital Markets
AT Brod & Co Inc	Investec Inc	Prudential Securities Inc	Citigroup Global Markets
Auerbach Pollak Richardson	Investors Associates Inc	RAF Financial Corp	Cowen & Co LLC
Banc of America Securities	J Gregory & Co Inc	RAS Securities Corp	Credit Suisse Securities
Baraban Securities Inc	James Capel & Co	Raymond James	Dawson James Securities
Barber & Bronson Inc	Janney Montgomery Scott	Redstone Securities Inc	Deutsche Bank Securities
Baring Securities	JC Bradford & Co	Rickel & Associates Inc	Dominick & Dominick Inc
Barington Capital Group	Joseph Stevens & Co LP	RJ Steichen & Co	EarlyBird Capital Inc
Barron Chase Securities Inc	Josephthal & Co	Robert W Baird & Co	FBR Capital Markets & Co
Beacon Securities Inc	JP Morgan Securities LLC	Robertson Stephens	Goldman Sachs
Bear Stearns & Co Inc	JW Charles Securities Inc	Robinson-Humphrey Co	Janney Montgomery Scott
Brenner Securities Corp	Keane Securities Co Inc	Rocky Mountain Securities	Jefferies & Co Inc

Hearing on *Legislation to Further Reduce Impediments to Capital Formation*

Chase H&Q
CIBC World Markets
Citigroup Global Markets
Commonwealth Associates
Comprehensive Capital Corp
Craig-Hallum Group
Credit Suisse First Boston
D Blech & Co
Dain Rauscher Wessels
Daiwa Securities America
Dean Witter Reynolds Inc
Deutsche Bank Securities
Deutsche Morgan Grenfell
DH Blair
Dickinson & Co
Dillon-Gage Securities Inc
Donaldson Lufkin & Jenrette
Equity Securities Investment
Everen Securities Inc
FAC/Equities
FEB Investments Inc
First Asset Management
First Equity Corp of Florida
First Hanover Securities Inc
First Marathon
Friedman Billings Ramsey
Gilford Securities Inc
GKN Securities Corp
Glaser Capital Corp
Global Capital Securities Corp
Goldman Sachs
Grady & Hatch & Co Inc
Greenway Capital Corp
Hamilton Investments Inc
Hampshire Securities Corp
Hanifen Imhoff Inc
Kennedy Mathews Landis Healy
Kensington Wells Inc
Kidder, Peabody & Co Inc
Kleinwort Benson Securities
Ladenburg Thalmann & Co Inc
Laidlaw Global Securities Inc
Lam Wagner Inc
Lazard Freres & Co LLC
LC Wegard & Co Inc
Legg Mason Wood Walker
Lehman Brothers
LH Alton & Co
Mabon Securities Corp
Marleau Lemire Securities Inc
Mathews Holmquist & Assoc.
McDonald Investments Inc
Merrill Lynch & Co
MH Meyerson & Co Inc
Miller Johnson & Kuehn
Montgomery Securities
Morgan Keegan & Co Inc
Morgan Stanley
Murchison Investment Bankers
NatCity Investments Inc
NatWest Securities Corp
Needham & Co Inc
Neidiger Tucker Bruner Inc
Nesbitt Burns Inc
Nomura Securities Intl
Norcross Securities Inc
Oak Ridge Investments Inc
Oppenheimer & Co
Oscar Gruss & Son Inc
Pacific Crest Securities LLC
Pacific Growth Equities LLC
PaineWebber Inc
Rodman & Renshaw Inc
Roney Capital Markets
Roth Capital Partners
Royce Investment Group Inc
RvR Securities Corp
Ryan Lee & Co Inc
Salomon Brothers Inc
Sands Brothers & Co Ltd
Schneider Securities Inc
Schroder & Co
SG Cowen & Co LLC
Smith Barney Inc
Spectrum Securities Inc
Spelman & Co
Stephens
Sterling Foster
Sterne Agee & Leach Inc
Strasbourger Pearson Tulcin
Stratton Oakmont Inc
Summit Investment Corp
Texas Capital Securities Inc
Thomas James Inc
Toluca Pacific Securities Corp
Tucker Anthony Inc
UBS Securities Inc
VTR Capital Inc
Wachovia Capital Markets
Wedbush Morgan Securities
Wells Fargo Securities LLC
Werbel-Roth Securities Inc
Wertheim Schroder & Co
Westfield Financial Corp
Whale Securities Co
William Blair & Co LLC
Yamaichi Securities
Yee Desmond Schroeder Allen
JP Morgan Securities LLC
Keefe, Bruyette & Woods
KeyBanc Capital Markets
Lazard Capital Markets
Leerink Swann LLC
Macquarie Capital
Maxim Group LLC
MDB Capital Group LLC
Morgan Stanley
Nuveen Investments
Oppenheimer & Co
Paulson Investment Co
Piper Jaffray & Co
PrinceRidge Group
Raymond James
RBC Capital Markets
Robert W Baird & Co
Sandler O'Neill & Partners
Santander Investment
Stephens
Stifel
SunTrust Robinson Hum
UBS Securities LLC
Wellington Shields Co LLC
Wells Fargo Securities
William Blair & Co LLC

July 2013, **Making Stock Markets Work to Support Economic Growth** (OECD Corporate Governance Working Papers)

September 2013, **The trouble with small tick sizes: Larger tick sizes will bring back capital formation, jobs and investor confidence**

June 20, 2012, **testimony** to the U.S. House of Representatives Financial Services Committee, Capital Markets and Government Sponsored Entities Subcommittee

June 8, 2012, **presentation** to SEC's Advisory Committee on Small and Emerging Companies

June, 2010 Market structure is causing the IPO crisis — and more

November 2009, **A wake-up call for America**

November 2008, **Why are IPOs in the ICU?**

Wall Street Journal Op-ed entitled, "**How to revive small-cap IPOs**," October 27, 2011

About David Weild

David is the Chairman & CEO of IssuWorks, which he recently founded to create technologies to improve equity capital formation and aftermarket support. IssuWorks owns Weild & Co. (formerly Capital Markets Advisory Partners or CMA Partners), a FINRA-registered broker-dealer.

Experience

David is an internationally recognized expert in how market structure affects capital formation. His work has been cited by academics, regulators and lawmakers in the US and overseas and the IPO Task Force Report to the U.S. Treasury. He was the former vice-chairman and executive vice-president of The NASDAQ Stock Market, with oversight of the more than 4,000 listed companies. Prior to NASDAQ, he spent 14 years at Prudential Securities in a number of senior management roles, including president of eCommerce, head of corporate finance, head of technology investment banking and head of equity capital markets in New York, London and Tokyo. He worked on more than 1,000 IPOs, follow-on offerings and convertible transactions and was an innovator of new issue systems and securities underwriting structures, including the use of Form S-3s to mitigate risk for small capitalization companies raising equity and convertible debt capital. He created the Market Intelligence Desk — or MID — while at NASDAQ to support issuers in their quest to better understand what was impacting trading in their stocks.

Education

David holds an MBA from the Stern School of Business and a BA from Wesleyan University. He has studied on exchange at The Sorbonne, Ecole des Haute Etudes Commerciales and The Stockholm School of Economics.

Industry participation

David has participated in the NYSE's and National Venture Capital Association's Blue Ribbon Regional Task Force to explore ways to help restore a vibrant IPO market and keep innovation flourishing in the United States, and is Chairman of the International Stock Exchange Executives Emeriti (ISEEE) Small Business Financing Crisis Task Force. He has spoken at the

OECD (Organisation for Economic Co-operation and Development) with the 35 member nations in attendance, plus the European Commission and IOSCO. David testified before the CFTC-SEC Joint Panel on Emerging Regulatory Issues in the wake of the May 2010 flash crash, and has spoken at the SEC a number of times, including the SEC Small Business Forum, the SEC Advisory Committee on Small and Emerging Companies and the SEC Roundtable on Decimalization. David is often interviewed by the financial news media. He has served as a Director of the National Investor Relations Institute's New York chapter, and he is the Chairman of the Board of Tuesday's Children, the non-profit that serves 9/11 families, and recently expanded its charter to make its long-term programs available to first responders, wounded warriors, families of the fallen and those touched by other acts of political and apolitical terrorism (e.g., Newtown).

Publications

David and Edward Kim have co-authored a number of studies, including *The trouble with small tick sizes: Larger tick sizes will bring back capital formation, jobs and investor confidence (Grant Thornton)* (with Lisa Newport) in 2012 and *Why are IPOs in the ICU? (Grant Thornton)* in 2008. Released in the fall of 2009, *Market structure is causing the IPO crisis (Grant Thornton)* (updated by *Market structure is causing the IPO crisis — and more* in 2010) and *A wake-up call for America (Grant Thornton)* have been entered into the Congressional Record and the Federal Register. They also authored *Making Stock Markets Work to Support Economic Growth (OECD)* (with Lisa Newport) and the chapter, *Killing the Stock Market That Laid the Golden Eggs (FT Press)* in the recent book on high frequency and predatory practices entitled, *Broken Markets,* by Sal Arnuk & Joseph Saluzzi, published in May 2012.

About IssuWorks

IssuWorks is the software and service firm focused on leveraging recent shifts in technology to create next generation platforms that will improve new issue performance and revitalize capital formation. IssuWorks' goal is to help investment banks, issuers, and the venture capital and private equity communities drive superior results by reducing the cost and complexity of new issue preparation while improving the distribution and aftermarket support of new issues. The combined effect will keep IPO "windows" open longer, resulting in higher throughput (more new issues). IssuWorks has a key strategic partnership with Netroadshow, the global standard for online roadshows for both public and private companies. IssuWorks is the exclusive computer-based marketing provider for Netroadshow, and they are our exclusive roadshow partner. Weild & Co., a wholly-owned subsidiary of IssuWorks, is a FINRA-registered broker-dealer.

Written Testimony of Gary K. Wunderlich, Jr.

Chief Executive Officer, Wunderlich Securities

Before the House Subcommittee on Capital Markets and Government Sponsored Enterprises

On behalf of the Securities Industry and Financial Markets Association

October 23, 2013

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee, thank you for the opportunity to appear before you today to discuss various legislative proposals to promote capital formation and job creation. My name is Gary Wunderlich, CEO of Wunderlich Securities, and I am testifying today on behalf of the Securities Industry and Financial Markets Association[1]. Wunderlich Securities is an independent investment firm and full service broker/dealer headquartered in Memphis with 28 offices in 16 states. We provide a full range of financial services to retail and institutional clients including investment banking, institutional sales and trading and research.

SIFMA and its member firms appreciate this Committee's dedication to a review of the environment for capital formation, and we are committed to working with you to evaluate and offer constructive recommendations to improve the wide-range of proposals that you are considering. America's success depends on a vibrant financial system that provides access to capital and credit at a reasonable price. The capital markets provide funding to people across America allowing them to build on their dreams of opening a small business, saving to send their children to college, buying their first home or saving for retirement. Our capital markets have changed dramatically in just the past few years so it is wholly appropriate for extensive public debate about what is working or not working in today's marketplace.

Changes in our economy and markets warrant evaluation and modernization of securities regulation in a manner that continues to protect investors, ensures the competitiveness of our markets and provides the efficient flow of capital to the many corners of our changing economy. In that regard, we welcome the opportunity to be here today.

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Tick-Size Pilot Discussion Draft (Rep. Duffy)

One area of capital formation that has been frequently debated over the past few years is the impact of decimalization on liquidity of small-cap and mid-cap issuers. Some have suggested that the move to decimalization has contributed to lower levels of liquidity in those stocks and that along with other factors, has impeded capital formation for those companies. Congress brought this issue into focus last year in passing the "JOBs Act". Section 106 of the "JOBS Act" directed the Securities and Exchange Commission (SEC) to conduct a study examining the effects of decimalization on initial public offerings (IPOs) and the liquidity of small and middle capitalization companies. The SEC submitted its report to Congress last July and included a literature review of a number of studies that had been conducted on the issue. The SEC recommended not proceeding with specific rulemaking to increase tick sizes, but rather considering additional steps that may be needed to determine whether rulemaking should be undertaken in the future. Since then, the topic has been discussed in a number of public forums, including Chairman Garrett's Equity Market Structure Roundtable this past May and an SEC Roundtable in February.

SIFMA and its members have also been engaged in an active dialogue about the impact of decimalization on small and mid cap issuers, and we generally believe that a pilot program which widens quote increments for small and mid cap securities could increase trading liquidity in those securities. Increased liquidity in the small and mid cap market will create a more fertile environment for small and emerging growth companies to tap the public markets, with broader market participation in the sector and the potential for increased research coverage to better inform and educate investors on both the opportunities and risks. We know that these companies can be an engine for economic growth, and the sponsors of these proposals are right to consider additional ways to ensure entrepreneurs have access to the capital they need.

While SIFMA is supportive of a pilot that explores how a wider tick size could benefit to small cap issuers, we oppose any pilot program that would prohibit trading within the wider quoting increments, as the current Discussion Draft contemplates. A prohibition on trading inside the quoting increment would be an unprecedented alteration of market practice and would prevent broker-dealers from providing price improvement to retail investors.

With respect to market practice, trading within the quoted spread has always been permitted. Before Regulation NMS and before the establishment of the stock exchanges themselves, market participants have always been able to meet in the middle on a negotiation over price. This includes periods when stocks were still traded in fractions instead of decimals (*e.g.,* 1/8ths of a dollar, instead of the current penny pricing). It is difficult to understand how such an alteration in market practice would facilitate the goal of increasing

liquidity for small-cap and mid-cap issuers. To our knowledge, there is no evidence to suggest that the goal of a tick size pilot to increase liquidity would be advanced by prohibiting trading within the wider quoting increments.

Perhaps more importantly, a trading restriction would have a negative impact on Main Street savers and retail investors. A consensus of most every market structure panel discussion or roundtable in recent months is that it has never been better to be a retail investor, as the options for routing trades have increased and as a result, trading costs have substantially decreased. Trading inside the spread allows broker-dealers to provide price substantial improvement at pricing increments within the established quoting increments. This happens routinely today when investors' trades are executed in non-exchange venues, allowing investors to "buy lower" and "sell higher" than they would otherwise. Just a few years ago, the SEC considered and rejected a trading restriction when it adopted the current penny-wide quoting increment, concluding that such price improvement benefits retail investors and is in the public interest. At that time, the SEC determined that trading in sub-penny increments does not raise the same concerns as sub-penny quoting, that sub-penny executions do not decrease depth at the posted quote (*i.e.*, do not reduce liquidity), and that sub-penny executions due to price improvement are generally beneficial to retail investors. The SEC's conclusion that it is in the public interest to allow trading within the spread is as relevant in 2013 as it was in 2005.

As with any market, free and open competition among trading venues has created pricing efficiencies for the end user – here, the retail investor – who benefits directly from lower trading costs. We are concerned that a restriction on trading increments would tilt the playing field in favor of certain venues over others, impair the robust competitiveness of this market, and accordingly, eliminate those price improvement opportunities that broker-dealers currently give their customers.

In addition, for any possible pilot program to be a success, it is critical to establish clearly stated metrics for use in evaluating the results of the pilot. And while SIFMA generally supports a pilot for widening quoting increments in small and mid cap securities, ideally we would like to see such a study take place as part of a broader review of U.S. market structure. Such a review should include the regulatory structure around exchange and off-exchange trading venues, the future of self-regulation, and a consideration of whether the comparative regulatory benefits and obligations facing exchanges and broker-dealers should be adjusted to reflect today's market realities. As SEC Commissioner Gallagher has noted at SIFMA's previous two market structure conferences, this review should have "no sacred cows."

Business Development Company Regulation (H.R. 31, H.R.1800 and H.R. 1973)

SIFMA supports efforts to modernize regulation of Business Development Companies (BDCs) as contemplated in the three bills we are discussing today. Since their creation, BDCs have been subject to

regulation under the Investment Company Act of 1940 subjecting them to certain statutory safeguards covering such areas as diversification, leverage, compliance and valuation. The BDC structure was created to promote public vehicles as a means to bring capital to small and medium sized businesses and by regulation, 70% of BDCs investments must be in private or small cap companies.

The JOBs Act provided for an onramp for Emerging Growth Companies (EGCs) to access the IPO market and has also created a framework for crowdfunding to bring capital to early stage entrepreneurs in much smaller increments. More can be done, however, to promote the flow of capital to private companies that are big enough to need larger amounts of capital to reach the next stage of their development but are still years away from an IPO. BDCs offer one such critical source of capital to eligible companies. BDC's have been active issuers in the last few years as they see opportunity to bring funds to attractive companies that are struggling to find capital at a reasonable cost from other sources.

Unfortunately much of the modernization of securities regulation that occurred in 2005 by way of Securities Offering Reform largely did not apply to BDCs. As a result, SIFMA believes that many unnecessary obstacles remain in place today so that BDCs are unable to efficiently access the markets and, in turn, provide much needed capital to middle market companies. We support efforts to align regulation for BDCs more closely with that of other public companies.

Since most BDCs are tax RICs (Regulated Investment Companies) and as a result are required to dividend out substantially all of their net income for tax purposes, BDCs are required to come to the public markets more regularly to raise capital in order to grow. The inability to utilize some of the built- in efficiencies in securities regulation for frequent corporate issuers, such as incorporating previously filed information by reference, creates unnecessary burdens. Moreover, since BDCs are generally unable to sell their shares below NAV (absent a shareholder vote among other things), they are even more sensitive to the need to access markets when conditions are favorable and so the inability for larger BDCs to qualify as Well-known Seasoned Issuer (WKSIs) and realize the benefits of automatically effective registration statements is also harmful. These types of hurdles impede BDCs in their mission to bringing much needed capital to the middle markets in a cost effective and efficient manner.

Lastly, SIFMA believes some incremental flexibility in the asset coverage ratio should be provided to BDCs to allow them to better fulfill their mission while at the same time maintaining sufficient safeguards to protect investors such as enhanced disclosure requirements, capital structure limitations, corporate governance and compliance requirements, affiliate transaction limitations and restrictions on leverage, all of which are applicable to BDCs by virtue of their being subject to compliance with the '40 Act and which are incremental to the safeguards applicable to other public companies.

Emerging Growth Company Discussion Draft (Rep. Fincher)

Congressman Fincher's discussion draft which would modify existing regulation of EGCs is also laudable and SIFMA supports each of the four provisions in the discussion draft.

Section 1 amends the Securities Act of 1933 to reduce the quiet period requirements from 21 days to 5 days for public filing prior to public offerings by EGC's. Currently, an EGC must file its registration statement publicly and must refrain from marketing the securities through its underwriters or otherwise for 21 days. In theory, this requirement allows for the dissemination, access and review of such information across the broader marketplace before a broker-dealer begins to actively market and solicit orders. In our experience however, this 21-day period is excessively long given the ready online access the public now possesses to such filings. The volatility in our markets can narrow the window of opportunity for an IPO to launch and price successfully and a 21-day quiet period inordinately and unnecessarily restricts an EGC's ability to come to market in a timely manner. We support a significant reduction in the quiet period as contemplated in the bill.

Sections 2 and 3 of the Discussion Draft add clarity and efficiency to two areas of securities regulation without impairing investor protection. Section 2 provides a grace period for a change in status of an EGC by allowing an issuer that qualifies as an EGC at the time of the filing of its confidential registration statement for review to continue to be treated as an EGC through the date on which it consummates its initial public offering. The limitation of the current regulatory construction, which would require the issuer to qualify as an EGC both at the time of confidential submission of the registration statement and at the time the registration statement is publicly filed, risks disincentivizing fast growing companies that could grow out of EGC status in the months required to essentially complete SEC review and make public the registration statement – despite having started the process with the SEC as an EGC.

Section 3 is designed to simplify the financial statement disclosure requirements for EGC's. Currently an EGC must include the previous two years of audited financials when it files its registration statement for review. The time required for SEC review could however cause the EGC to roll into a new fiscal year before it launches its IPO, and as such the relevant two-year period may change. For example, an EGC may file its registration statement in the third or fourth quarter of 2013, and accordingly include in that filing full audited financial statements (and related Management Discussion and Analysis) for 2011 and 2012. If, however, the IPO does not launch until 2014, the 2011 audited financial statements generally would no longer be required for the offering. The cost and effort to create audited financial statements (and related narrative disclosures) for IPO issuers are significant, and is an entirely unnecessary burden for them where those financial statements will not be required to be included in a preliminary prospectus or final prospectus

distributed to investors. It is our understanding that other securities regulators (for example, the UK FSA) currently permit the suggested approach.

The last provision in the bill extends the ability for EGC's to file a confidential registration statement not only for their initial public offering but also for a follow-on offering. The JOBS Act provided this confidential filing with a recognition that EGC's do not want to make proprietary information public too early or otherwise prematurely disclose their intention to make an offering—and thereby impair their competitive standing if there is risk that market dynamics or the time required for SEC review may force them to delay (or abandon) an offering. The new provision extends that same reasoning to follow-on offerings so that EGC's are able to derive a similar benefit for those offerings and thus encourage them to engage in further capital raising or sales on behalf of their founding investors.

Conclusion

SIFMA welcomes your continued interest in supporting capital formation through appropriate regulatory relief. Many in government often try to distinguish Main Street from Wall Street but the capital allocation function provided by my Memphis, Tennessee firm and thousands of others across this country supports the creation and expansion of tens of thousands of small businesses who are truly the backbone of our economy and the best hope we have for robust job creation moving forward. Again referring to Commissioner Gallagher's quote that there should be no sacred cows as we evaluate how our markets have evolved and what more can be done to improve their function, SIFMA strongly supports the work of this Committee to facilitate capital formation and create jobs and we look forward to continued constructive engagement throughout this process.

FINANCIAL SERVICES ROUNDTABLE

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October 22, 2013

The Honorable Scott Garrett
Chairman
House Financial Services Committee
Capital Markets & Government
Sponsored Enterprises Subcommittee
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Committee
Capital Markets & Government
Sponsored Enterprises Subcommittee
Washington, D.C. 20515

Dear Chairman Garrett and Ranking Member Maloney:

The Financial Services Roundtable is writing to express our support of the "Next Steps for Credit Availability Act (H.R. 31)"; "Small Business Credit Availability Act (H.R. 1800)"; and the "Business Development Company Modernization Act (H.R. 1973)." These bills will make it easier for Business Development Companies (BDC) to lend to small and mid-sized businesses. BDC's are designed to facilitate capital formation for small and middle-market companies. BDC's play a vital role in funding the businesses that keep the economy stimulated.

We request your support in moving these bills forward.

Please contact me at 202 589-2416 if you have any questions.

Best Regards,

Scott Talbott
Senior Vice President of Public Policy
Financial Services Roundtable

PROSPECT

Testimony Submitted by Joseph Ferraro,
General Counsel, Prospect Capital Corporation
before
The House Subcommittee on Capital Markets and Government Sponsored Enterprises
on
"Legislation to Further Reduce Impediments to Capital Formation"
October 23, 2013

Mr. Chairman, Ranking Member Maloney, and Members of the Committee, thank you for the opportunity to submit this written testimony. My name is Joseph Ferraro and I am General Counsel to Prospect Capital, a leading provider of capital to job-creating small and medium-sized companies in the United States.

Prospect is a publicly-traded business development company, or BDC. Our company completed its initial public offering in July 2004, and since then we have invested more than $5.5 billion in over 175 small and medium-sized companies to expand their businesses, hire workers, construct factories, and achieve other important objectives. Our capital has helped create thousands of American jobs over the years, and our capital is much needed in this critical period of high unemployment and economic uncertainty.

In 1980, Congress enacted amendments to the Investment Company Act of 1940 authorizing BDCs to facilitate financing of small and medium-sized businesses. Deciding which of these businesses to finance requires rigorous credit analysis and significant and time consuming due diligence. These activities are uneconomical for traditional banks to perform and involve transaction sizes too small for many other capital providers.

Put simply, a BDC is a lender to and investor in small and medium-sized businesses that might not otherwise receive financing.

As I testified in June of this year, our industry believes that modest changes to our securities laws can greatly enhance the ability of BDCs to serve the capital needs of small and medium-sized companies without undermining investor protections. These changes have been recommended by bills introduced by Representatives Mulvaney, Velazquez, and Grimm.

While my June testimony described in some detail the benefits of each of these measures, today I want to focus on H.R. 1973.

Under current law a BDC must invest at least 70% of its assets in so-called "eligible assets" – namely public micro-cap and private companies. But current law excludes financial services companies from qualifying as "eligible portfolio companies." Thus, no more than 30% of a BDC's assets can be invested in financial services companies.

This outdated limitation makes no sense. The financial services sector encompasses a wide array of companies including community banks, leasing companies, factoring firms, and automobile financing companies. BDC investments in small- to medium-sized American financial services businesses are consistent with the principal purpose for which Congress created BDCs – to provide capital and assistance to small, developing businesses that are seeking to expand and create American jobs. The law should not artificially limit a BDC's ability to provide capital to such companies. H.R. 1973 would remove this artificial 30% cap on these types of investments.

In its October 21, 2013 letter to Chairman Garrett and Ranking Member Maloney, the SEC has raised two concerns regarding the scope of H.R. 1973. Specifically, the SEC raised concerns that removing the cap on investments in private equity and hedge fund investments could allow a BDC to become a conduit for non-accredited retail investors to invest in such financial entities. The Committee can address such concerns by tightening the language in H.R. 1973 to retain the existing law limitations on such investments contained in paragraphs (1) and (7) of section 3(c) of the Investment Company Act of 1940. This modification to H.R. 1973 would fully address the SEC's concerns while retaining the general intent of the legislation.

Additionally, in explaining its understanding of the original purpose for excluding financial service entities from the definition of "eligible portfolio company", the SEC generally paraphrases the legislative history behind the 1980 amendments to the Investment Company Act of 1940 creating BDCs. The SEC describes this limitation as "intended to encourage a BDC to focus its investment activities on operating companies that directly produce goods or provide services rather than on other financial institutions that serve primarily as conduits of capital." Thirty-three years later, many of the investments that H.R. 1973 would treat as eligible investments are not mere passive "conduits of capital", but rather are themselves active, developing and expanding small- and middle-market companies that provide an array of critical services to other small- and middle-market companies – exactly the kind of "operating companies" in need of the small business investment BDCs are incentivized to provide. Thus, the changes recommended by H.R. 1973 are consistent with the BDC mission of making capital available to small and middle-market companies.

Lastly, I want to address a misunderstanding about how BDCs raise and deploy capital. Any suggestion that if a BDC were to make larger investments in financial service companies it would have fewer assets to invest in other types of companies presumes that a BDC has a finite amount of capital to deploy. That is simply not the case. BDCs regularly raise capital in the markets and look for opportunities to make new investments. It is the availability of quality investments that dictate how much capital a BDC can raise and invest. Thus, expanding the pool of eligible investments does not mean a BDC will merely reallocate or divert existing capital. Instead, enacting H.R. 1973 means BDCs will be able to expand capital access to the very companies that BDCs were created to serve.

Again, we appreciate the Committee's consideration of legislation to reduce impediments to capital formation. We believe that modernizing the rules that govern BDCs will help to expand capital access for small and middle-market companies.

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Michael F. Foley, PhD
President and CEO

The Honorable Elizabeth Esty
509 Cannon House Office Building
Washington, D.C. 20515

Dear Representative Esty:

I am writing this letter in support of the BDC model as a means for raising funds to support the capital needs of middle market growth companies. I was an executive at Reflexite Corporation (in Avon, CT) for the last 16 years, most recently serving as the CEO until my retirement this year. Reflexite produces optical components and films for Safety, Lighting, Instrumentation, and Display Markets. You may not have heard of our company, which was on track to sell $180M in product this year, but you would certainly know our products. For instance, we make friend or foe ID's for the US military, diffusers for more energy efficient lighting systems, lens arrays for solar power generation, and traffic control products for nighttime safety on our roads. Before we sold the company in 2011, we were an employee owned company and were named one of the Wall Street Journal's Top 15 Small Workplaces in America in 2007.

There are times when companies need to raise money away from the limitations of traditional senior debt providers or private equity firms. In our case, Reflexite needed to raise capital to facilitate the buyout of my predecessor and to grow new product lines. Traditional bank sources were not a good fit as their proposed capital was inflexible, they had low tolerance for risk as we grew new businesses, and they could not meet the size of the capital commitment we needed. Similarly, private equity sources were not a good match as they wanted to be able force liquidity within a certain time frame. This is fundamentally incompatible with a private company who wishes to preserve autonomy and to invest in growth. Our company was majority owned by its employees and our shareholders enjoyed a return in excess of 12% compounded over the last 30 years. We did not want to sell the company until we felt it was ready, which was on our own timetable, not one that was provided by our bankers.

The BDC model is one of "permanent capital" - because the money is raised on the public market there is no fixed timeframe for liquidity. And because BDC's distribute the profits of their companies back to shareholders as dividends, BDC's present an attractive alternative for value/long term/fixed income investors who don't want to see their returns compromised by short term thinking. Ares Capital became our partner and offered many advantages besides a long term orientation. A number of senior executives of Ares sat on our Board of Directors and provided invaluable strategic advice and counsel as our firm grew and changed.

We did eventually sell the company, when we got to a point where we needed to be part of an even bigger company to continue to succeed in the marketplace. But in the meantime, we enabled the American dream for many in our workforce, the vast majority of whom are still employed with the company years after the sale. Many of our hourly factory floor workers retired with stock accounts worth more than $1 million. I can honestly say that we could not have achieved our success without the help from Ares Capital and the BDC model.

Sincerely,
REFLEXITE CORPORATION

Michael F Foley

Michael F Foley, PhD
President and CEO (retired)

cc:

The Honorable Jeb Hansarling
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

October 23, 2013

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee
on Capital Markets and GSEs
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Subcommittee
on Capital Markets and GSEs
B301C Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee,

On behalf of the Small Business Investor Alliance (SBIA), the nation's premier organization of lower middle market investors, thank you for holding this hearing to consider "Legislation to Further Reduce Impediments to Capital Formation." We appreciate the opportunity to make our comments available to the Committee as part of the hearing record.

SBIA has examined the regulatory landscape for BDCs and concluded that the current regime hinders, not promotes, healthy and competitive private markets for small businesses accessing capital. Current BDC regulations are outdated and unnecessarily burdensome - making the BDC capital raising process less flexible, less efficient, and more expensive than necessary. This lack of modernization particularly hurts smaller BDCs investing in smaller businesses. The SBIA supports the reforms in H.R. 1800 and H.R. 31 and we look forward to working with the Committee to make any improvements stemming from this hearing in preparation for a markup. The SBIA believes elements of H.R. 1973 would improve current law, but we have concerns about negative consequences relating to some of the language. We would welcome the opportunity to work with the Committee to make needed improvements to the bill prior to a mark up.

The SBIA spearheaded a letter[1] to the Securities and Exchange Commission (SEC) on October 7, 2013, requesting the modernization of BDC regulations and the opportunity to discuss policy changes affecting the asset coverage ratio. 24 BDCs signed the letter, representing almost half of the BDCs in the marketplace today. We again attach this letter because it clearly defines specific problems facing small business investors and outlines our support for the regulatory modernizations included in H.R. 31 and H.R. 1800. These commonsense reforms, most of which should have been corrected in 2005 when the SEC adopted final rules related to Securities Offering Reform, would streamline the registration and

[1] Petitions for Rulemaking Submitted to the SEC; File No. 4-667; Request for rulemaking to modernize the regulations of Business Development Companies; Submitted by Brett Palmer, Small Business Investor Alliance; October 7, 2013.

offering process by allowing BDCs to incorporate already filed information by reference; allowing BDCs to obtain well-known seasoned issuer status; permitting BDCs to use free writing prospectuses; and allowing BDCs to pre-file shelf registration statements for continuous or delayed offerings. We know of no objections to these reforms. Even the Chair of the SEC, Commissioner White, wrote in her letter to this Committee on October 21, 2013 that the regulatory modernization provisions contained in H.R. 31 and H.R. 1800 "do not raise significant investor protection concerns." However, without Congressional action we do not believe that the SEC will make any reforms, even these reforms that would ultimately benefit small businesses.

Chairwoman White's letter to the Committee expressed her concerns about potential changes to the asset coverage ratio. However she does not mention that, even the most strident critics of changing the asset coverage ratio believe there may be certain circumstances where greater flexibility under the asset coverage ratio might be appropriate. We encourage the SEC to seriously consider the BDC industry's request to discuss proposals to prudently modify the asset coverage ratio instead of dismissing the issue without discussion. The SBIA supports the bills but also has viable alternatives worthy of discussion and would welcome the opportunity to work with the Committee and the SEC to consider all options for providing prudent flexibility for the asset coverage ratio.

H.R. 31, H.R. 1800, and H.R. 1973 all would allow BDCs to own investment advisers. Since passage of Dodd-Frank, several BDCs have sought and received exemptive relief to own registered investment advisers subject to certain conditions. Each exemptive application requires a BDC to prepare an individualized filing, typically with the assistance of legal counsel, to be made to the SEC. Upon receipt of the BDC's filing, the SEC may take months or even years to grant the requested relief. Adopting this provision would level the playing field between the BDCs who have received exemptive relief and those that are in the process of attempting to obtain such relief.

The "eligible portfolio company" provision of H.R. 1973, as currently written, is major change that is overly broad that will have adverse effects on the BDC industry if adopted in its current form. We stand ready to help the Committee correct this language in order to prudently expand the eligible portfolio company definition.

Thank you again for holding this important hearing and we look forward to working with you to reduce regulatory barriers to capital formation.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance

October 7, 2013

The Honorable Mary Jo White
Chairwoman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Commissioner White:

As an industry we formally request that the SEC modernize the regulatory burdens on Business Development Companies.

Business Development Companies (BDCs) were created by Congress in 1980 to encourage the establishment of public vehicles to increase the flow of capital to small, growing U.S. businesses, a critical component of the U.S. economy. BDCs make direct investments in smaller, developing American businesses thereby providing access to capital to the middle market that is not otherwise available through traditional funding sources such as banks or the public equity capital markets. Despite the critical role BDCs perform, current BDC regulation has made it extremely difficult for BDCs to deliver on their mission to fund small and medium sized small businesses starved of growth capital.

Rationalizing BDC regulations will support American jobs and foster economic growth by improving access to the public capital markets for BDCs to invest in emerging growth companies. By any standard, BDCs provide more disclosure and are subject to more regulation than other traditional public companies. The current restrictions on BDCs make the capital raising process for BDCs less flexible, less efficient, and more expensive than necessary– which ultimately reduces each BDC's ability to invest in growing U.S. businesses.

In late 2005, the SEC adopted final rules relating to Securities Offering Reform, which were the most sweeping liberalization and modernization of the registered offering process under the 1933 Act in decades. The majority of these updates did not apply to BDCs. At the time the rule revisions were implemented, the Commission promised to consider reforms for BDCs at a later date - this never happened. Consequently BDCs have been left behind on an uneven playing field with other public companies seeking to access the capital markets.

Despite this arcane regulatory framework, the number of BDCs operating today has more than doubled since Securities Offering Reform was enacted, and over that time the industry has invested billions of dollars into growing U.S. businesses, thus creating or supporting thousands of U.S. jobs. This alone demonstrates the significant demand for growth capital that BDCs are filling – but much more could be accomplished. With a modern regulatory framework, the BDC industry could further expand, fill the market demand, and provide billions more in growth capital to small and medium-sized businesses.

We formally ask the SEC to modernize the regulation of BDCs. The BDC industry respectfully requests the following:

- Include BDC regulatory modernization as a major agenda item of the SEC's Forum on Small Business Capital Formation this November and in future years.
- Take formal action to modernize how BDCs raise capital by making applicable to BDCs the rules that apply to traditional public companies, specifically:
  - Allow BDCs to incorporate already-filed information by reference into current registration statements with the Commission as other public companies do;
  - Allow BDCs to file automatic shelf registration statements and therefore be afforded ready access to the capital markets by permitting qualification for BDCs under the definition of "Well-Known Seasoned Issuer" (WKSI) as other public companies do;
  - Permit BDCs to release factual and forward-looking business information by using free-writing prospectuses, as other public companies do;
  - Allow BDCs to communicate with investors more freely during the preparation and filing periods for a registration statement, as other public companies do;
  - Allow broker-dealers and other providers of market research more flexibility to disseminate research, thereby providing more information to the market and shareholders;
  - Provide a safe harbor to BDCs for disseminating additional information during an offering, as other public companies do;
  - Allow a BDC to file a shelf registration statement for continuous or delayed offerings on the same form used by other public companies;
  - Synchronize BDC prospectus filing requirements with those of other public companies, which Congress contemplated in 1980 when the BDC model was created;
  - Provide regulatory parity by relieving BDCs of the requirement to provide written confirmations of sales, notifications of allocation, and deliveries of securities; and
  - Allow preferred stock to be treated as equity, not debt.

- We believe that BDCs should be permitted to own or acquire securities or other interests in registered investment advisers or other advisers to investment companies. This 1940 Act prohibition serves no obvious policy purpose. In fact, the Commission has routinely provided exemptive relief to BDCs to permit the ownership of investment advisers in the last several years. Formalization of this position would permit BDCs more flexibility in their business models and structures without changing the important policy protections of the 1940 Act.

- BDCs are significantly limited as to their use of borrowings such that they may not exceed a 1-to-1 debt to equity ratio. We believe there may be circumstances under which greater flexibility might be appropriate. The Commission should immediately engage the BDC industry to review and propose changes to the asset coverage ratio under which BDCs must operate, specifically focusing on the benefits of a modest reduction in such ratio and any appropriate market safeguards that should be required.

We ask for your prompt consideration of these matters. Please contact Brett Palmer, President, Small Business Investor Alliance, regarding the Commission's response to this letter. Mr. Palmer can be contacted by mail at 1100 H St., NW, Suite 610, Washington, DC 20005; by phone at (202) 628-5055; or by email at bpalmer@sbia.org.

Sincerely,

Curtis Hartman
SBIA, BDC Committee Chairman
Senior Managing Director and
Chief Credit Officer
Main Street Capital Corporation

David Gladstone
Chairman and CEO
Gladstone Investment Corporation
Gladstone Capital Corporation

Lawrence E. Golub
Chief Executive Officer
Golub Capital

Manuel A. Henriquez
Chairman and CEO
Hercules Technology Growth Capital, Inc.

Todd Huskinson
Chief Financial Officer
Stellus Capital Investment Corporation

Theodore L. Koenig
Chairman and CEO
Monroe Capital

Steven C. Lilly
Chief Financial Officer
Triangle Capital Corporation

B. Hagen Saville
President and CEO
MCG Capital Corporation

Alvin Murstein
Chairman and Chief Executive Officer
Medallion Financial Corp.

James K. Hunt
Chairman and CEO
THL Credit, Inc.

Brook Taube
Chairman and CEO
Medley Capital Corporation

Bernard D. Berman
President
Fifth Street Finance Corp. and Fifth Street
Senior Floating Rate Corp.

Steve Gardner
President and CEO
NGP Capital Resources Company

Timothy J. Keating
Chairman and CEO
Keating Capital, Inc.

Howard Levkowitz
Chairman and CEO
TCP Capital Corp.

Robert A. Hamwee
President and CEO
New Mountain Finance Corporation

Allen F. "Pete" Grum
President and CEO
Rand Capital Corporation

Douglas W. Jamison
Chairman and CEO
Harris & Harris Group, Inc.

Edward H. Ross
Chairman and CEO
Fidus Investment Corporation

Brian Chase
Chief Financial Officer
Garrison Capital Inc.

Art Penn
Chief Executive Officer
PennantPark Investment Corporation and
PennantPark Floating Rate Capital

Nicholas Radesca
Chief Financial Officer
Business Development Corporation of
America

Christian L. Oberbeck
Chairman and CEO
Saratoga Investment Corp.

Joseph B. Alala, III
President and CEO
Capitala Investment Advisors, LLC

cc:
The Honorable Luis A. Aguilar, U.S. Securities and Exchange Commissioner
The Honorable Daniel M. Gallagher, U.S. Securities and Exchange Commissioner
The Honorable Kara M. Stein, U.S. Securities and Exchange Commissioner
The Honorable Michael S. Piwowar, U.S. Securities and Exchange Commissioner
The Honorable Jeb Hensarling, Chairman, U.S. House Committee on Financial Services
The Honorable Maxine Waters, Ranking Member, U.S. House Committee on Financial Services
The Honorable Tim Johnson, Chairman, U.S. Senate Committee on Banking, Housing and Urban Development
The Honorable Mike Crapo, Ranking Member, U.S. Senate Committee on Banking, Housing and Urban Development

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIR

October 21, 2013

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Capital Markets and
Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Maloney:

I understand that the Capital Markets Subcommittee of the House Financial Services Committee will be discussing at an upcoming legislative hearing three bills that would amend provisions of the Investment Company Act of 1940 (Act) concerning business development companies (BDCs): H.R. 31 (the Next Steps for Credit Availability Act); H.R. 1800 (the Small Business Credit Availability Act); and H.R. 1973 (the Business Development Company Modernization Act). I write to briefly provide background on BDCs and to draw your attention to certain features of these bills. Please note that the views expressed in this letter are my own and do not necessarily reflect the views of the full Commission or any Commissioner.

As of June 30, 2013, there were 68 active BDCs with aggregate total assets of $53.7 billion. While BDCs account for a small percentage of the assets managed by all regulated investment companies, assets managed by BDCs have grown rapidly over the past decade from net assets of just $5 billion at the end of 2003. Much of this growth is from newly organized BDCs sponsored by large private capital managers. Most BDCs sell a fixed number of shares in periodic offerings and most (about 85%) provide investors with liquidity by listing their shares on a stock exchange. Significantly, most securities issued by BDCs, whether traded or not, are held by retail investors.

Congress created BDCs in 1980 as a specialized type of closed-end investment company (*i.e.*, a fund that is not required to repurchase or redeem its securities) whose principal activities consist of investing in, and providing managerial assistance to, small, growing, or financially troubled domestic businesses. To this end, the Act generally requires a BDC to invest at least 70% of its portfolio assets in cash (or high quality, short-term debt securities), securities issued by financially troubled businesses, or certain securities issued by domestic companies that:

- do not have a security listed on a national securities exchange (i.e., are private companies), or have a security listed on a national securities exchange but have less than $250 million of common shares outstanding;
- are not investment companies; and

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- would not be investment companies but for an exclusion from the definition of "investment company" in section 3(c) of the Act.

The remaining 30% of a BDC's portfolio assets are not limited by these investment restrictions and can be invested freely.

Under the Act, BDCs enjoy greater operating flexibility than mutual funds or other closed-end funds. A BDC, for example, may issue long term options and warrants, may issue multiple classes of debt securities, and may issue approximately 50% more debt securities as a percentage of capital than other investment companies. As discussed below, H.R. 31 and H.R. 1800 would ease that regulatory structure by permitting a BDC to double its permitted borrowings and issue an unlimited amount of preferred stock, thereby increasing the risk of loss from such leverage for BDC shareholders and holders of senior securities issued by BDCs.

H.R. 31 and H.R. 1800

Both H.R. 31 and H.R. 1800 would amend section 61(a) of the Act to: (a) reduce the asset coverage for senior securities representing indebtedness from 200% to 150%; and (b) make inapplicable the 200% asset coverage requirement for senior securities that are stock, *i.e.*, preferred stock, and other provisions of the Act intended to protect holders of preferred stock.[1] In my view, this increase in the ability of BDCs to use leverage, and the elimination of provisions of the Act intended to protect holders of preferred stock issued by a BDC, gives rise to investor protection concerns, particularly because most BDC shareholders are retail investors.

The Act's asset coverage requirements exist for the protection of both a BDC's shareholders on one hand and investors in its senior securities on the other.[2] Leverage amplifies both negative and positive portfolio performance. As the percentage of a BDC's capital from senior securities increases, the greater is the amplification. Increased leverage increases earnings volatility. At the same time, the risk increases that the BDC will lack the resources to pay

[1] Asset coverage is the ratio of total assets less liabilities other than senior securities to senior securities. The asset coverage requirement for senior securities issued by a BDC is 200%. For other closed-end funds, the asset coverage requirement is 300% for debt securities and 200% for preferred stock. An asset coverage of 300% is approximately equivalent to a debt to equity ratio of 1:2; an asset coverage of 200% is approximately equivalent to a debt to equity ratio of 1:1.

[2] When Congress enacted the Act, the highly capitalized and simplified capital structure that the Act imposes on investment companies was regarded as being of central importance to the protection of investors. Prior to 1940, the use of excessive leverage and complex capital structures by certain closed-end funds led to personal gain for insiders at the expense of public security holders. In some instances, debt and preferred stock sold to the public accounted for a disproportionate amount of a fund's capital, but common stock concentrated in the hands of insiders controlled the fund. Although a fund's assets might be insufficient to liquidate the senior securities, insiders could induce the fund to pay distributions with respect to the common stock or repurchase common stock. *See Investment Trusts and Investment Companies* pt. 3, H.R. Doc. No. 279, 76th Cong., 1st Sess. 1001, 1582-97 (1939). In this regard, section 1(b) of the Act identifies "excessive borrowing and the issuance of excessive amounts of senior securities [i.e., preferred stock or debt securities]" as one of the principal abuses the Act was designed to address.

promised interest or dividends, or the principal or liquidation preference, to the holders of its senior securities.

The risk that a BDC will be unable to make timely payments to senior security holders is, in my view, of particular concern in view of the illiquid types of investments that BDCs make. The asset coverage provisions act as a circuit breaker. If a BDC's asset coverage of its senior securities is less than 200% (after giving effect to the distribution, issuance or repurchase), the BDC may not make cash distributions to shareholders, issue additional senior securities, or repurchase common stock and must retain for the BDC's use cash that the BDC otherwise would pay to its shareholders as distributions.[3]

Both H.R. 31 and H.R. 1800 would permit a BDC to significantly increase its leverage in two specific ways. First, the amendments to the Act proposed in those bills would reduce the asset coverage requirement for debt securities to 150% from 200%, thereby increasing the debt to equity ratio from approximately 1:1 to 2:1. By way of example, under current law, a BDC with $100 in equity could borrow $100 (equal to $200 total assets). If that BDC's assets lost 50% of their value, its shareholders would experience a total loss on their equity investment. Reducing the required asset coverage to 150% would permit the same BDC to borrow $200, effectively doubling its leverage. A BDC's assets would only have to lose 33 1/3% of their value before exposing shareholders to a total loss of their investment.

Second, the proposed amendments would allow a BDC to issue an unlimited amount of preferred stock, effectively eliminating the Act's limitations on leverage. Because the proposed amendments would treat the issuance of preferred stock as the equivalent of the issuance of common stock for purposes of calculating asset coverage, a BDC could increase its leverage by issuing preferred stock and thereby actually increase its capacity for issuing additional debt securities.

Both H.R. 31 and H.R. 1800 also would eliminate all of the provisions in the Act specifically intended to protect the holders of preferred stock issued by a BDC.[4] A potential

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[3] Debt securities issued by a BDC also provide that if: (a) asset coverage declines to less than 100% for one year then the holders of those securities have the right to elect a majority of the BDC's directors; or (b) asset coverage declines to less than 100% for 24 consecutive months then a default shall be deemed to have occurred. Failing to meet the asset coverage requirements, however, is not a violation of the Act, and the BDC is not forced to sell assets.

[4] The Act provides that holders of preferred stock, voting separately as a class, are entitled to: (a) elect at least two directors at all times; (b) elect a majority of the directors if at any time dividends on the preferred stock have been in arrears for two full years; (c) approve or disapprove any plan of reorganization adversely affecting their interests; and (d) approve or disapprove certain other major corporate events, such as converting to a mutual fund format. These voting rights help balance the sometimes conflicting interests of the holders of the common stock and the holders of the preferred stock issued by the same fund. Under the Act, a BDC may not issue different classes of preferred stock, *i.e.*, classes with different priorities as to the payment of dividends or liquidation preference. In liquidation, if the value of a BDC's assets is insufficient to satisfy the claims of all security holders, holders of a class with a higher priority have a clear advantage. Absent liquidation, that priority can influence the market value of a security, particularly during times when a particular BDC's prospects dim. Retail investors might find a junior class of preferred stock with a high dividend rate attractive but fail to appreciate the risks in the event that the BDC

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consequence is the sale to retail investors of preferred stock with a confusing mix of characteristics and rights. Under the Act, for example, preferred stock has "complete priority" over the common stock as to payment of dividends, and dividends are cumulative. This provision prohibits the sale of participating preferred stock or preferred stock that is preferred only as to assets in liquidation but not as to dividends. But for these provisions, holders of preferred stock could find that dividends not paid during lower earnings periods are never paid, even if the BDC subsequently prospers.

The two bills also would: (a) amend section 60 of the Act to permit a BDC to purchase securities issued by registered investment advisers; and (b) direct the Commission to revise certain rules under the Securities Act of 1933 to put BDCs on parity with other issuers that are required to file certain reports under the Securities Exchange Act of 1934. In my view, these provisions do not raise significant investor protection concerns.

H.R. 1973

By amending the Act's definition of "eligible portfolio company" to include currently excluded financial institutions, H.R. 1973 would change the definition and stated purpose of BDCs. The Act defines "business development company" as a closed-end fund that is "operated for the purpose of making investments in securities" issued by small or financially distressed companies, generally companies that meet the Act's definition of "eligible portfolio company." This definition requires that, with one exception,[5] an eligible portfolio company be neither an investment company, as defined in Act, nor a company that is excluded from the definition of investment company solely by section 3(c) of the Act, *i.e.*, financial institutions such as hedge funds, private equity funds, brokers and consumer finance companies. The Act, however, does not prohibit a BDC from investing in financial institutions or other companies that are not eligible portfolio companies; under the Act, a BDC can invest up to 30% of its portfolio in securities issued by these companies.

The explicit exclusion of investment companies and other financial institutions from the definition of "eligible portfolio company" was intended to encourage a BDC to focus its investment activities on operating companies that directly produce goods or provide services rather than on other financial institutions that serve primarily as conduits of capital. Congress created BDCs in response to "the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses."[6] To the extent that a BDC concentrates its

experiences financial reversals. A BDC in financial distress, for example, might eliminate dividend payments to holders of a junior class of preferred stock but continue dividend payments to holders of a senior class.

[5] The one exception allows an eligible portfolio company to be a small business investment company (SBIC) licensed by the Small Business Administration that is a wholly owned subsidiary of a BDC. A SBIC makes investments that are consistent with the purpose of BDCs.

[6] H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20 (1980). The House Report states that "[t]he importance of these businesses to the American economic system in terms of innovation, productivity, increased competition and the jobs they create is, of course, critical." *Id.*

investments in other financial institutions, it would divert capital from small, growing businesses that BDCs were originally created to help.

While Congress obviously can choose to change the purpose of BDCs in this manner, of particular concern is the prospect of a BDC concentrating its investments in hedge and other private funds because of the riskier strategies associated with some of these funds. This raises potential investor protection concerns, as it would allow non-accredited investors to invest in a BDC comprised entirely of private funds. As such, BDCs could be used to circumvent the general prohibition on selling interests in private funds to retail investors.

I hope that this information is helpful to you and to the other members of the Subcommittee. Please do not hesitate to contact me at (202) 551-2010, or have your staff contact Tim Henseler, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2015, if I can be of any further assistance.

Sincerely,

Mary Jo White
Chair

cc: Chairman Jeb Hensarling
Ranking Member Maxine Waters

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Arlington, VA 22201-2149
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Carrie R. Hunt
Senior Vice President of Government Affairs
and General Counsel

NAFCU
National Association of Federal Credit Unions | www.nafcu.org

October 22, 2013

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on
Capital Markets & GSEs
United States House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Subcommittee on
Capital Markets & GSEs
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association that exclusively represents the interests of our nation's federal credit unions, I write in conjunction with the subcommittee hearing being held tomorrow entitled, "Legislation to Further Reduce Impediments to Capital Formation." Credit unions and their 96 million members urge your additional consideration of legislation that would reduce impediments to capital for our nation's small businesses by allowing credit unions to better assist in lending efforts.

As you know, there was a severe reduction in the availability of capital during the financial crisis. This credit crunch is still being felt by many small business owners today. As the economy recovers, credit unions continue to serve as an important resource for small businesses to obtain capital oftentimes in the event that they have been turned away from other financial service providers. While credit unions are equipped to help small businesses, their efforts, unfortunately, are severely hindered by the arbitrary credit union member business lending cap. This cap is denying our nation's small businesses all the tools they need to grow and spur economic activity such as job creation. With this in mind, Representatives Ed Royce and Carolyn McCarthy introduced bipartisan legislation, the *Credit Union Small Business Jobs Creation Act of 2013* (H.R. 688) to raise the arbitrary credit union member business lending cap. Both the Treasury Department and the National Credit Union Administration (NCUA) have signed-off on this proposal that would create jobs without spending a single dime of taxpayer funds.

Another impediment to credit unions providing much needed capital is their inability to access supplemental forms of capital. Under current law, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth can dilute a credit union's regulatory capital ratio. Representatives Peter King and Brad Sherman have introduced bipartisan legislation, the *Capital Access for Small Businesses and Jobs Act of 2013* (H.R. 719), that would address this problem by authorizing the NCUA to allow credit unions to access supplemental forms of capital that do not alter their cooperative nature. This would further minimize the probability of credit union insolvency, ensure they are able to maximize lending to small businesses, and allow them to grow to meet the needs of their members.

We urge you and your colleagues to consider and support these two bipartisan commonsense legislative proposals. Enacting these bills would help reduce impediments to capital formation at our nation's small businesses. If you have any questions or require additional information, please contact me or Jillian Pevo, NAFCU's Director of Legislative Affairs, at 703-842-2836 or jpevo@nafcu.org.

Sincerely,

Carrie R Hunt

cc: Members of the House Financial Services Subcommittee on Capital Markets and GSEs